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Statement of the Shadow Financial Regulatory Committee

on

The Failure of the Treasury's Study of the Federal Deposit Insurance System to Focus on Identifying and Correcting Defects in Governmental Incentives

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The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) directs the Secretary of the Treasury to study the federal deposit insurance system for the purpose of recommending reforms. As part of this study, the Treasury has requested public comments on a wide range of subordinate issues.

Extensive comments on the most important of the Treasury's selected issues may be found in past policy statements of this Committee and in the writings of many individual Committee members. These analyses develop the guideline that deposit-insurance officials should measure, monitor, price, and police institution risk exposures in the same ways that market discipline would lead a well-managed stockholder-owned firm to perform these tasks in a private enterprise setting. In particular, Committee Policy Statement No. 41 offers a plan based on graduated capital ratios designed to give bank stockholders and debtholders strong incentives to take self-protecting actions that would keep institutions from being operated with inadequate or negative capital.

Missing from the Treasury's topic outline is the recognition that the deposit insurance system also suffers because elected and appointed officials face strong incentives to breach the private-enterprise guideline. As thrift-industry insolvencies and FSLIC's cumulative capital shortage grew, authorities repeatedly sought to buy time. But they used this time badly with respect to their fiduciary responsibilities to well-capitalized institutions and taxpayers. They employed gimmicky accounting to paper over industry and insurance-fund weaknesses and to defer fully adequate corrective action to someone else's watch. As politically attractive as this policy was in the short run, not requiring the recapitalization or closure of insured institutions when they neared insolvency imposed enormous, but not immediately accounted for, longer-run costs on taxpayers.

An institution becomes economically insolvent when explicit and implicit losses push the earning power of its assets below the level needed to service its debts. Because deposit liabilities are federally guaranteed, insolvent deposit institutions have no difficulty in funding at below-market interest rates growth-oriented, go-for-broke forms of risk-taking that are inefficient for society as a whole. This ease of financing encourages risky strategies.

The FSLIC collapse demonstrates defects in political and bureaucratic accountability that, if not corrected, will undermine the FDIC as well. The Treasury study must address two core issues before deposit insurance can be properly reformed. First, why did elected and appointed officials charged with overseeing the deposit insurance agencies break faith with taxpayers by putting off needed insolvency resolutions for years on end? Second, how can the authorities' incentives be restructured to assure that they will serve taxpayers' interests scrupulously in the future?

The overriding problem is that covering up troublesome evidence and engaging in regulatory forbearance is, at least for strictly self-interested politicians and bureaucrats, a rational response to widespread industry insolvency. The current system confronts authorities with a painful trade-off between protecting general taxpayers' economic interests and incurring the displeasure of politically strong regulatory clients and their various political allies.

To overcome this tradeoff, the incentives bearing on the exercise of judgment and discretion of bureaucratic decision-makers must be reconstructed and the scope of that discretion must be greatly narrowed with respect to the information they report and the forbearance they give. To forestall cover-ups, deposit insurers and their clients must be required to estimate the long-run costs of regulatory forbearances honestly and in a timely fashion. To lessen congressional pressure for granting forbearances, estimated losses should be put into agency budgets and flowed through the federal budget in the year they occur. This would provide an informational framework in which market and political forces would push deposit insurers to enforce timely recapitalization of troubled deposit institutions. In addition, members of Congress should be required to report all efforts to win forbearance for constituent firms to their ethics and banking committees for examination and potential sanction. Finally, these committees should hold regular hearings during which outside experts are asked to assess compliance with these new requirements by regulators and politicians.

This informational framework should apply to banks as well as to thrifts. A threshold for reorganizing an insured institution's affairs should be established at a positive rather than negative level of net worth, measured in terms of market values. Although a number of transitional difficulties need to be addressed, regulators and deposit institution managers can, if higher authorities insist, develop workable procedures for marking to market on-balance sheet and off-balance sheet items often enough to provide timely appraisals of the economic net worth of every federally insured enterprise and of the net value of the deposit insurance reserves that stand behind them.

At the same time, the statutory provisions governing deposit insurance managers should be narrowed and made more precise, leaving little room for regulatory judgment and the play of political pressure.

The Committee wants to emphasize that the past operation of the deposit insurance system did not go wrong only because of incentives facing the managers of insured institutions, but also because of the incentive problems facing public officials. A study that ignores the second dimension of the 1980s' disaster cannot hope to develop an effective solution.