

8. Safety Nets, Deposit Insurance, and Subsidies

Entries in this section include works on bank safety nets in general and deposit insurance in particular. Also covered are the costs of official government safety nets, their benefits, the existence of safety net-related banking subsidies and their competitive implications, and policies for containing such subsidies.

Bankers Roundtable. 1997. The Federal Safety Net—Subsidy Effects in and outside of Banks. Occasional Paper no. 3. Bankers Roundtable.

In discussions about modernizing the laws that govern the financial marketplace, the argument has been advanced that banks and affiliated companies enjoy subsidy benefits from the federal safety net. This subsidy may be defined as a benefit from the government which results in a distortion in the marketplace, including a competitive economic advantage for banks. The authors argue that the federal safety net provides certainty for insured depositors and stability for financial markets but has little if any effect on banks as competitors. The authors conclude that the safety-net subsidy or its transfer should not be a major issue for financial modernization.

Benston, George J. 1989. The Federal “Safety Net” and the Repeal of the Glass–Steagall Act’s Separation of Commercial and Investment Banking. *Journal of Financial Services Research* 2, no. 4:287–305.

If banks were allowed to engage in securities activities, it is feared that the federal safety net—deposit insurance, the Fed’s role as lender-of-last resort, and government intervention to prevent financial crises—might be strained and possibly broken as banks’ risk-taking increased. An analysis of methods of controlling risk-taking and bankers’ present ability and propensity to take risks leads to a contrary conclusion. Nevertheless, the concern has given rise to a considerable body of empirical work. Studies on bank failures, risk-return profiles, cash flows, and profits and losses from underwriting are reviewed critically. On the whole, both the empirical and theoretical analyses provide little reason for concern about the federal safety net. (©1999 EconLit)

Burnett, Amy, Ramesh K. S. Rao, and Seha M. Tinic. 1991. Subsidization of S&Ls under the Flat-Rate Deposit Insurance System: Some Empirical Estimates. *Journal of Financial Services Research* 5 no. 2:143–64.

This study analyses the thrift institutions’ asset volatilities over the 1955–88 period and finds that deregulation in the industry has not led to a systematic increase in risk-taking in the industry. Through examining the magnitude of the subsidies by S&L holding companies under the present flat-rate deposit insurance system, the authors discover that a flat-rate deposit insurance system provides uneven and inequitable distribution of subsidies among thrift institutions. The authors find that a large fraction of the asset volatilities is attributable to firm-specific investment policies and that the risk of institutions’ assets change considerably over time. Taken as a whole, the results suggest that switching to a

risk-based deposit insurance system would be economically efficient. The authors conclude by recommending policy changes that can increase the efficacy of risk-based insurance by increasing the level of monitoring by depositors and the financial markets.

Calomiris, Charles W. 1997. *The Postmodern Bank Safety Net: Lessons from Developed and Developing Economies*. American Enterprise Institute.

This analysis of the government safety net for the financial system begins with a review of the changes that have taken place in the twentieth century in policies and attitudes. Chapter 1 discusses the expansion of protection between the 1930s and the early 1980s, the period when an extensive “modern” safety net was constructed. Chapter 2 shows how new evidence in the mid-1980s began to alter attitudes and policies within the United States and in other economies. In chapter 3, the author considers alternative solutions to the incentive problems of the safety net and compares two approaches to reforming government safety nets, one based on the 1988 Basle International Bank Capital Standards and provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991, the other a potentially more promising approach to reforming government safety nets. Chapter 4 reviews and evaluates two prominent examples of recent reform in the light of the arguments of chapter 3: namely, the experiences of Chile and Argentina, countries that have injected elements of private market discipline into their safety-net reforms. Chapter 5 offers some conclusions.

Demirgüç-Kunt, Asli, and Harry Huizinga. 1999. *Market Discipline and Financial Safety Net Design*. Policy Research Working Paper no. 2183. The World Bank.

The authors examine cross-country data on bank-level interest expense and deposit growth for evidence of market discipline in individual countries. In addition, using cross-country information on deposit insurance systems, they investigate the effect of explicit deposit insurance (and its key features) on bank interest rates and market discipline. They find that it is difficult to design and implement an effective safety net for banks, because overgenerous protection of banks may introduce a risk-enhancing moral hazard and destabilize the very system it is meant to protect. The safety net that policymakers design must provide the right mix of market and regulatory discipline—enough to protect depositors without unduly undermining market discipline of banks.

Emmons, William Robert. 1992. *Essays on the Regulation of Financial Institutions*. Ph.D. diss., Northwestern University.

This dissertation investigates the theory of banking safety nets, comprising the central bank’s discount window and deposit insurance. The author also examines evidence to test whether the U.S. banking crisis of the 1980s and 1990s was primarily due to distress in the “real economy” or to increased risk-taking by banks. In the first essay, a theoretical model is developed in which demandable debt keeps the incentives of bankers and depositors aligned. The second essay shows that “small” banking systems benefit from a mutual guarantee of deposits. The third essay investigates the recent rise in bank failures and concludes that

bank failures are more likely when increased risk-taking coincides with a bad local economy.

Enoch, Charles, Peter Stella, and May Khamis. 1997. Transparency and Ambiguity in Central Bank Safety Net Operations. Working Paper no. WP/97/138. International Monetary Fund.

To mitigate the risks of contagion from problems arising in the banking sector, many countries operate some form of banking-sector safety net. Such safety nets generally involve a judicious mixture of transparency and ambiguity. This ambiguity may be important to counter moral-hazard effects but may lead to excessive forbearance in the face of banking problems. Although the scope for ambiguity has been declining, some ambiguity in the handling of individual institutions remains. In any case, ex post transparency is essential for reviewing the propriety of any assistance and preserving the authorities' future reputation and policy credibility.

Isard, Peter, Donald J. Mathieson, and Liliana Rojas-Suarez. 1996. A Framework for the Analysis of Financial Reforms and the Cost of Official Safety Nets. *Journal of Development Economics* 50, no. 1:25–79.

This paper builds a multiperiod, general equilibrium framework for analyzing the macroeconomic effects of financial reforms in developing countries and the costs of maintaining official safety nets. When the creditworthiness of the nonfinancial sector is weak, the efficiency gains from financial liberalization may be countered by an increase in expected deposit insurance funding obligations, even when prudential supervision is strong. Moreover, given the distortions in a repressed financial system, attempts to reduce risk exposures by increasing bank capital/asset ratios may increase the funding obligations associated with deposit insurance, particularly when the debt-servicing capacity of nonfinancial firms is low. (©1999 EconLit)

Jones, Kenneth, and Barry Kolatch. 1999. The Federal Safety Net, Banking Subsidies, and Implications for Financial Modernization. *FDIC Banking Review* 12, no. 1:1–17.

Many policymakers and economists have long maintained that the federal safety net—broadly defined as federal deposit insurance and access to the Federal Reserve System's discount window and payments system—endows insured depository institutions with a financial subsidy and with certain other, nonfinancial, competitive advantages. Others have also asserted that banks could conceivably pass cost advantages on to their bank subsidiaries and affiliates—in essence, extending the safety net to activities for which it was not intended. During congressional hearings on proposed financial modernization legislation, the presumed existence of a government subsidy and a bank's alleged ability to pass it to its subsidiaries became a particularly important issue. This article reexamines the subsidy issue in light of recent regulatory reforms prompted by the thrift and banking crises of the 1980s. After reassessing the traditional arguments claiming that safety net–related subsidies exist and have competitive implications, the article argues that for public-policy purposes the relevant question is not

whether a gross subsidy exists, but whether a net marginal subsidy remains after full account is taken of all offsetting costs. Finally, the article discusses the effectiveness of firewalls and other regulatory efforts to prevent the transfer of any subsidy and to limit taxpayer exposure.

Kane, Edward J. 1995. What Is the Value-Added for Large U.S. Banks in Offering Mutual Funds? Working Paper no. W5111. National Bureau of Economic Research.

This paper argues that an implicit deposit-insurance credit enhancement is extended to any nondeposit savings vehicle offered by a very large bank. This unpriced credit enhancement helps to explain the preference revealed by very large U.S. banks for gearing up to offer mutual funds instead of developing index-linked deposit products. It also explains why large banks have been more eager than small banks to offer mutual funds and why bank mutual funds could be priced to grow at a time when bank deposits were being priced to shrink. (©1999 EconLit)

Keehn, Silas. 1989. Banking on the Balance: Powers and the Safety Net. Monograph. Federal Reserve Bank of Chicago.

The regulatory structure of the financial industry has seen significant and generally desirable changes in the 1980s. These have occurred on an issue-by-issue basis and have not been the result of a comprehensive reappraisal. However, the changing needs of the banking public and production-efficiency arguments call for additional regulatory changes. This monograph outlines existing proposals and describes a new one that can be implemented within the existing regulatory framework and requires minimal legislative changes.

Kwast, Myron, and Wayne Passmore. 1997. The Subsidy Provided by the Federal Safety Net: Theory, Measurement, and Containment. Finance and Economics Discussion Series, no. 1997-58. Board of Governors of the Federal Reserve System.

Considerable controversy surrounds the question of whether the government's commitment to preventing a systemic crisis in the banking system and to protecting small depositors by maintaining a federal safety net for insured depository institutions also provides a subsidy to banks. This paper presents an intuitive and analytical model of how the safety net affects banks' cost of funds. The paper's emphasis is on the distinction between fixed and marginal costs in banking and on the implications of the model for measuring the subsidy. Empirical results strongly suggest that the safety net has benefited banks and that over recent years bank holding companies have tended to move activities into a bank or a bank subsidiary. The authors conclude that limiting the extension of the safety-net subsidy should be a serious concern when strategies are designed for expanding bank activities.

Lehnert, Andreas, and Wayne Passmore. 1999. *The Banking Industry and the Safety Net Subsidy*. Finance and Economics Discussion Series, no. 1999-34. Board of Governors of the Federal Reserve System.

Governments use monetary policies to counteract the effects of financial crises. The authors examine the subsidy that such safety-net policies provide to the banking industry. Using a model of uncertainty-driven financial crises, they show that any monetary policy designed to maintain risky investment in the face of investor uncertainty (and thus promote economic growth and stability) will subsidize the banking industry. In addition, they show that the *mere presence* of a monetary authority willing to support a failing banking system in bad times subsidizes the banking industry, even if those bad times do not occur. A conditional bailout policy that does not extend equally to all financial institutions creates a greater subsidy for those institutions perceived as being “close” to the central bank, possibly giving these institutions a competitive advantage.

Mantripragada, Krishna G. 1991. *The Role of Market-Value Accounting in Reducing Potential Taxpayer Subsidies: The Case of Deposit Insurance*. *Public Budgeting and Finance* 11, no. 4:20–32.

This article studies the role that market-value accounting can play in reducing potential taxpayer subsidies to the deposit insurance program. It examines the relationship between the accounting system and losses to the deposit insurance program, discusses problems in implementing market-value accounting, and shows how market-value accounting can improve the effectiveness of the system of public regulation and reduce the adverse financial consequences of regulatory discretion. Although the direct focus of the article is on deposit insurance reform, the discussion and arguments are applicable to improving the regulatory effectiveness of other public agencies and programs.

Mishra, Chandrasekhar, and Jorge L. Urrutia. 1995. *Deposit Insurance Subsidies, Moral Hazard, and Bank Regulation*. *Journal of Economics and Finance* 19, no. 1:63–74.

The model developed in the paper separates deposit insurance subsidies into two components: a premium-linked subsidy which arises from an ex-ante mispricing of the deposit insurance premium, and an asset-linked subsidy which arises from a lack of ex-post monitoring of the bank’s actions. The identification of these two subsidies provides important insight into the relation between deposit-insurance subsidies and bank risk. The asset-linked subsidy is higher for banks of average risk and lower for very-high and very-low risk banks. The premium-linked subsidy behaves differently under risk-adjusted and fixed-rate schemes. The model also indicates that the implementation of a risk-adjusted insurance-rate schedule alone would not be sufficient to eliminate the bank’s excessive risk-taking behavior. Thus, some combination of risk-sensitive deposit-insurance pricing and regulatory control is necessary to reduce the moral hazard problem. (©1999 EconLit)

Osterberg, William P., and James B. Thomson. 1991. *The Effect of Subordinated Debt and Surety Bonds on the Cost of Capital for Banks and the Value of Federal Deposit*

Insurance. *Journal of Banking and Finance* 15, no. 4-5:939-53. Also 1990. The Effect of Subordinated Debt and Surety Bonds on the Cost of Capital for Banks and the Value of Federal Deposit Insurance. Working Paper no. 9012. Federal Reserve Bank of Cleveland.

This paper examines two proposals to reduce the subsidy to risk-taking embedded in the current deposit insurance system and to protect the deposit insurance fund. The two proposals are (1) requiring banks to issue subordinated debt and (2) requiring bank stockholders to post surety bonds. The authors use the cash-flow version of the capital asset pricing model (Chen, 1978) to show how each proposal affects the values and rates of return on uninsured deposits and equity. They also find that only if deposit insurance is mispriced can either affect the values of the FDIC claim and the bank. (©1999 EconLit)

Santomero, Anthony M. 1997. Deposit Insurance: Do We Need It and Why? *Ekonomia* 1, no. 1:1-19. Also 1997. Deposit Insurance: Do We Need It and Why? Working Paper no. 97-35. Wharton Financial Institutions Center, Wharton School of Business, University of Pennsylvania.

The existence of an efficient intermediary sector is an essential ingredient to a productive economy. To protect the real sector from financial fragility, a series of circuit breakers have been established, known collectively as the financial safety net. One part of this system, deposit insurance, has proven the most difficult to manage. While it adds stability, its effects on bank decision making, risk tolerance, depositor behavior, and sector stability are all problematic. This has led many to question its validity as a stability tool, and still others to propose alteration in its coverage and pricing. Nowhere is the problem of appropriate insurance coverage more difficult than in the European Union. (©1999 EconLit)

Scott, William, L., and Michael F. Lockett. 1992. Commercial Banks' Expanding into Securities Underwriting: The Equity Market's Risk Assessment. *Journal of Economics and Finance* 16, no. 3:37-47.

Government officials must decide if the payments system and deposit insurance funds would be endangered by allowing commercial banks to underwrite corporate securities. In this study the authors provide evidence on the issue by evaluating the perspectives of equity investors in investment banking concerns. Dealer exposures to capital markets (investment banking and market making) are not perceived to contribute to their marginal riskiness--either systematic or nonsystematic. However, investment exposures to capital markets (merchant banking and principal transactions) add to both systematic and nonsystematic risks of participating firms. Along with the accounting-based previous research, these findings suggest granting new securities powers that are solely dealer-based. (©1999 EconLit)

Shaw, Karen D. 1993. What Should Deposit Insurance Protect? *Bankers Magazine* 176, no. 5:60–63.

The banking industry is used to measuring the cost of deposit insurance by the millions of dollars it sends each year as premiums to the FDIC. Those premiums, however, are only a fraction of the true cost of the insurance. With growing awareness by Congress and two administrations that deposit insurance protects against a less-than-remote risk (a point the savings and loan rescue made clear), regulation, supervision, and examination of insured institutions and their holding companies have increased dramatically. However, the disparity between the premiums banks pay and the funding advantage they may receive suggests that deposit insurance may still represent a net subsidy from the federal government.

Stern, Gary H. 1998. Government Safety Nets, Banking System Stability, and Economic Development. *Journal of Asian Economics* 9, no. 1:21–29.

The number, breadth, and cost of banking crises in developed and developing countries in the latter half of the twentieth century are unprecedented. While many factors contributed to the crises, the moral hazard associated with explicit and implicit government deposit insurance has been cited as a likely cause in a significant number of cases. A potential method for addressing moral hazard is to eliminate government deposit insurance programs and outlaw ex post government support for depositors. This option could lead to instability in the banking system and would likely lack the credibility needed to reduce moral hazard. Instead, deposit insurance reforms should balance the objectives of stability and moral hazard cost reduction. In this paper, the author proposes a plan, with co-insurance at its core, to increase market discipline while minimizing any increase in instability. Enacting legal reforms that balance these competing goals is particularly important in developing countries, as the extent and quality of a country's financial infrastructure is a significant determinant of economic development. (©1999 EconLit)

Walter, John R. 1996. Firewalls. Federal Reserve Bank of Richmond *Economic Quarterly* 82, no. 4:15–39.

Since the banking crisis of the early 1930s, laws and regulations have restricted banks' transactions with their nonbank affiliates. These restrictions, commonly known as firewalls, are meant to prevent the spread of financial difficulties within a banking company. In certain circumstances, banking company owners gain from shifts of nonbank losses to affiliated banks while the federal deposit insurance fund loses. Firewalls may provide a valuable regulatory tool for containing banking company owners' incentives to employ such shifts. (©1999 EconLit)

Walter, John R. 1998. Can a Safety Net Subsidy Be Contained? Federal Reserve Bank of Richmond *Economic Quarterly* 84, no. 1:1–20.

Banks may receive a subsidy from deposit insurance or from other components of the government-provided banking safety net. Extension (leakage) of a subsidy to

banks' nonbank affiliates will only serve to enlarge it. But subsidy enlargement, since it entails expanded risks to taxpayers and reduced economic efficiency, seems to demand steps to prevent it. To contain bank-to-affiliate leaks, observers propose intracompany restrictions. While such restrictions may contain intracompany leaks, they cannot contain broader subsidy enlargement. Competition will compel banks to yield any subsidy to their borrowers and depositors, thereby frustrating public-policy attempts to limit it. (©1999 EconLit)

Whalen, Gary. 1997. The Competitive Implications of Safety Net-Related Subsidies. Economics Working Paper no. 97-9. Office of the Comptroller of the Currency.

This paper provides evidence on the competitive implications of safety net-related subsidies. The author discusses the existing evidence on the determinants and size of a potential subsidy stemming from possibly mispriced deposit insurance; outlines potential supervisory tools that might mitigate any subsidy or prevent its transfer to direct bank subsidiaries or holding company affiliates; presents and discusses a set of subsidy estimates for the 50 largest domestic bank holding companies; and gives some market evidence that provides insight on the existence and size of any subsidy.