appendix to chapter 11

Evaluating FDICIA and Other Proposed Reforms of the Banking Regulatory System

FDICIA is a major step in reforming the banking regulatory system. How well will it work to solve the adverse selection and moral hazard problems of the bank regulatory system? Let's use the analysis in the chapter to evaluate the most important provisions of this legislation to answer this question.

Study Guide

Before looking at the evaluation for each set of provisions and proposals in this application, try to reason out how well they will solve the current problems with banking regulation. This exercise will help you develop a deeper understanding of the material in this chapter.

Limits on the Scope of Deposit Insurance

FDICIA's reduction of the scope of deposit insurance by limiting insurance on brokered deposits and restricting the use of the too-big-to-fail policy might have increased the incentives for uninsured depositors to monitor banks and to withdraw funds if the bank is taking on too much risk. Because banks might now fear the loss of deposits when they engage in risky activities, they might have less incentive to take on too much risk. Limitations on the use of the too-big-to-fail policy starting in 1992 have resulted in increased losses to uninsured depositors at failed banks as planned.

Although the cited elements of FDICIA strengthen the incentive of depositors to monitor banks, some critics of FDICIA would take these limitations on the scope of deposit insurance even further. Some suggest that deposit insurance should be eliminated entirely or should be reduced in amount from the current $100,000 limit to, say, $50,000 or $20,000. Another proposed reform would institute a system of *coinsurance* in which only a percentage of a deposit—say, 90%—would be covered by insurance. In this system, the insured depositor would suffer a percentage of the losses along with the deposit insurance agency. Because depositors facing a lower limit on deposit insurance or coinsurance would suffer losses if the bank goes broke, they will have an incentive to monitor the bank's activities. Other critics believe that FDICIA provides too much support for the too-big-to-fail policy. Because under FDICIA the Fed, the Treasury, and the FDIC can still agree to implement too-big-to-fail and thus bail out uninsured as well as insured depositors, big banks will not be subjected to enough discipline by uninsured depositors. These critics advocate eliminating the too-big-to-fail policy entirely, thereby decreasing the incentives of big banks to take on too much risk.

However, other experts do not believe that depositors are capable of monitoring banks and imposing discipline on them. The basic problem with reducing the scope of deposit insurance even further as proposed is that banks would be subject to runs, sudden withdrawals by nervous depositors. Such runs could by themselves lead to bank failures. In addition to protecting individual depositors, the purpose of deposit insurance is to prevent a large number of bank failures, which would lead to an unstable banking system and an unstable economy as occurred periodically before the establishment of federal deposit insurance in 1934. From this perspective, federal deposit insurance has been a resounding success. Bank panics, in which there are simultaneous failures of many banks and consequent disruption of the financial system, have not occurred since federal deposit insurance was established.

On the one hand, evidence that the largest banks benefiting from the de facto too-big-to-fail policy before 1991 were also the ones that took on the most risk suggests that limiting its application, as FDICIA does, may substantially reduce risk taking. On the other hand, eliminating the too-big-to-fail policy altogether would also cause some of the same problems that would occur if deposit insurance were eliminated or reduced: The probability of bank panics would increase. If a big bank were allowed to fail, the repercussions in the financial system might be immense. Other banks with a correspondent relationship with the failed bank (those that have deposits at the bank in exchange for a variety of services) would suffer large losses and might fail in turn, leading to a full-scale panic. In addition, the problem of liquidating the big bank's loan portfolio might create a major disruption in the financial market.

Prompt Corrective Action

The prompt corrective action provisions of FDICIA should also substantially reduce incentives for bank risk taking and reduce taxpayer losses. FDICIA uses a carrot-and-stick approach to get banks to hold more capital. If they are well capitalized, they receive valuable privileges; if their capital ratio falls, they are subject to more and more onerous regulation. Increased bank capital reduces moral hazard incentives for the bank, because the bank now has more to lose if it fails and so is less likely to take on too much risk.

In addition, encouraging banks to hold more capital reduces potential losses for the FDIC, because increased bank capital is a cushion that makes bank failure less likely. Furthermore, forcing the FDIC to close banks once their net worth is less than 2% (group 5) rather than waiting until net worth has fallen to zero makes it more likely that when a bank is closed, it will still have a positive net worth, thus limiting FDIC losses.

Prompt corrective action, which requires regulators to intervene early when bank capital begins to fall, is a serious attempt to reduce the principal–agent problem for politicians and regulators. With prompt corrective action provisions, regulators no longer have the option of regulatory forbearance, which, as we have seen, can greatly increase moral hazard incentives for banks.

Some critics of FDICIA feel that there are too many loopholes in the bill that still allow regulators too much discretion, thus leaving open the possibility of regulatory forbearance. However, an often overlooked part of the bill increases the accountability of regulators. FDICIA requires a mandatory review of any bank failure that imposes costs on the FDIC. The resulting report must be made available to any member of Congress and to the general public upon request, and the General Accounting Office must do an annual review of these reports. Opening up the actions of the regulators to public scrutiny will make regulatory forbearance less attractive to

them, thereby reducing the principal–agent problem. It will also reduce the incentives of politicians to lean on regulators to relax their regulatory supervision of banks.

Risk-Based Insurance Premiums

Under FDICIA, banks deemed to be taking on greater risk, in the form of lower capital or riskier assets, will be subjected to higher insurance premiums. Risk-based insurance premiums will consequently reduce the moral hazard incentives for banks to take on higher risk. In addition, the fact that risk-based premiums drop as the bank's capital increases encourages the bank to hold more capital, which has the benefits already mentioned.

One problem with risk-based premiums is that the scheme for determining the amount of risk the bank is taking may not be very accurate. For example, it might be hard for regulators to determine when a bank's loans are risky. Some critics have also pointed out that the classification of banks by such measures as the Basel risk-based capital standard solely reflects credit risk and does not take sufficient account of interest-rate risk. The regulatory authorities, however, are encouraged by FDICIA to modify existing risk-based standards to include interest-rate risk and, as we have seen earlier in the chapter, have proposed guidelines to encourage banks to manage interest-rate risk.

Other FDICIA Provisions

FDICIA's requirements that regulators perform bank examinations at least once a year are necessary for monitoring banks' compliance with bank capital requirements and asset restrictions. As the S&L debacle illustrates, frequent supervisory examinations of banks are necessary to keep them from taking on too much risk or committing fraud. Similarly, beefing up the ability of the Federal Reserve to monitor foreign banks might help dissuade international banks from engaging in these undesirable activities.

The stricter and more burdensome reporting requirements for banks have the advantage of providing more information to regulators to help them monitor bank activities. However, these reporting requirements have been criticized by banks, which claim that the requirements make it harder to lend to small businesses.

Other Proposed Changes in Banking Regulations

Regulatory Consolidation. The current bank regulatory system in the United States has banking institutions supervised by four federal agencies: the FDIC, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Reserve. Critics of this system of multiple regulatory agencies with overlapping jurisdictions believe it creates a system that is too complex and too costly because it is rife with duplication. The Clinton administration proposed a consolidation in which the duties of the four regulatory agencies would be given to a new Federal Banking Commission governed by a five-member board with one member from the Treasury, one from the Federal Reserve, and three independent members appointed by the president and confirmed by the Senate. The Federal Reserve strongly opposed this proposal because it believed that it needed to have hands-on supervision of the largest banks through their bank holding companies (as is the case currently) in order to have the information that would enable the Fed to respond sufficiently quickly in a crisis. The Fed also pointed out that a monolithic regulator might be less effective than two or more regulators in providing checks and balances for regulatory supervision. The Clinton administration's proposal was not passed by Congress, but the issue of regulatory consolidation is sure to come up again.

Market-Value Accounting for Capital Requirements. We have seen that the requirement that a bank have substantial equity capital makes the bank less likely to fail. The requirement is also advantageous, because a bank with high equity capital has more to lose if it takes on risky investments and so will have less incentive to hold risky assets. Unfortunately, capital requirements, including new risk-based measures, are calculated on a historical-cost (book value) basis in which the value of an asset is set at its initial purchase price. The problem with historical-cost accounting is that changes in the value of assets and liabilities because of changes in interest rates or default risk are not reflected in the calculation of the firm's equity capital. Yet changes in the market value of assets and liabilities and hence changes in the market value of equity capital are what indicate if a firm is truly insolvent. Furthermore, it is the market value of capital that determines the incentives for a bank to hold risky assets.

Market-value accounting when calculating capital requirements is another reform that receives substantial support. All assets and liabilities could be updated to market value periodically—say, every three months—to determine if a bank's capital is sufficient to meet the minimum requirements. This market-value accounting information would let the deposit insurance agency know quickly when a bank was falling below its capital requirement. The bank could then be closed down before its net worth fell below zero, thus preventing a loss to the deposit insurance agency. The market-value-based capital requirement would also ensure that banks would not be operating with negative capital, thereby preventing the bet-the-bank strategy of taking on excessive risk.

Objections to market-value-based capital requirements center on the difficulty of making accurate and straightforward market-value estimates of capital. Historical-cost accounting has an important advantage in that accounting rules are easier to define and standardize when the value of an asset is simply set at its purchase price. Market-value accounting, by contrast, requires estimates and approximations that are harder to standardize. For example, it might be hard to assess the market value of your friend Joe's car loan, whereas it would be quite easy to value a government bond. In addition, conducting market-value accounting would prove costly to banks because estimation of market values requires the collection of more information about the characteristics of assets and liabilities. Nevertheless, proponents of market-value accounting for capital requirements point out that although market-value accounting involves some estimates and approximations, it would still provide regulators with more accurate assessment of bank equity capital than historical-cost accounting does.

Overall Evaluation

FDICIA appears to be an important step in the right direction, because it increases the incentives for banks to hold capital and decreases their incentives to take on excessive risk. However, more could be done to improve the incentives for banks to limit their risk taking. Yet eliminating deposit insurance and the too-big-to-fail policy altogether may be going too far, because these proposals might make the banking system too prone to a banking panic.