Deposit Insurance in a Deregulated Environment: Discussion
Author(s): Paul M. Horvitz
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DISCUSSION

PAUL M. HORVITZ*: This is an important paper. Its focus is on the feasibility of private deposit insurance, but it discusses issues that arise in the context of deposit insurance that have broader implications for finance theory. It is unfortunate that space limitations prevent that authors from discussing these implications in more detail, and I hope they will carry on from where this paper leaves off.

The paper begins with what the authors claim are the "two basic questions currently at issue" with respect to deposit insurance. The answers to those questions are easy: "no," the existing system of federal deposit insurance does not provide appropriate incentives with respect to risk-taking by insured institutions; and "yes," the current system extends the government's guarantee to an inappropriate extent. Fortunately, the paper does not stop with answers to these questions, but goes on to deal with the resulting, tougher question: what can be done about this problem?

The academic literature has long proposed risk-related insurance premiums as the efficient solution. I do not believe that a move toward risk-related deposit insurance premiums (such as that now being planned by the FDIC) is the right solution, and recent work by Pyle, and Costa and Greenbaum suggests that that position may be gaining respectability.

Apart from the risk-related premiums approach, the solution to the deposit insurance problem most frequently referred to in the economic literature is that of private deposit insurance as a substitute or supplement to federal insurance. The discussion of private insurance in the literature has been rather casual, usually consisting of nothing more than assertion that if the federal government can do it, than the private sector can also, or the argument by analogy that if the private sector can provide insurance against earthquakes or mortgage loan defaults, than it can also provide deposit insurance.

Some of the operational aspects of the feasibility of private deposit insurance are discussed in a paper by Glenn and Campbell for the FSLIC report on deposit insurance mandated by the Garn-St. Germain Act. That report (and the corresponding report by FDIC) consider such issues as the limited capital of the casualty insurance industry, and the need for a governmental guarantee of private insurance.

This paper, however, represents the first analysis of the essential elements of

* University of Houston.

the theory of private, voluntary deposit insurance. It concludes that private deposit insurance turns on such factors as the nature of the liabilities of depository institutions, alternative insolvency systems, the nature of the insurance contract, and measurement costs. None of these considerations are obvious, nor would their importance be apparent from earlier comments on the feasibility of private deposit insurance. Further, the emphasis on the insolvency system represents a real contribution to our understanding of the nature of bankruptcy costs.

One problem for a deposit insurance system is the determination of when insolvency occurs and insured depositors are to be paid off. The existence of a credible deposit insurance system means that even though the deposits are "instantaneously putable" to the firm, depositors are willing to hold deposits in an institution whose liabilities exceed its assets. Depository institutions are not subject to bankruptcy law as are ordinary business firms, but are subject to closure by the supervisory agencies. This means that insured institutions face a different insolvency system than other firms, and also that a private insurance company may have a different contract than a government system. A life insurance company cannot cancel a policy when the insured is on his death bed, but the FDIC can (with cooperation from the chartering authority) close a bank in deteriorating condition *before* its net worth becomes significantly negative. If the FDIC does so, its losses are zero. Its costs are monitoring costs, and its risks are measurement errors, rather than the risks of bank failure.

It is not feasible to grant to private deposit insurance companies the right to cancel insurance whenever they want to, or depositors will be left unprotected just when they need protection. The purpose of deposit insurance is to prevent runs as depositors flee a bank thought to be failing. But neither it is feasible to grant to private insurers the right to close an institution. The profit-maximizing insurer will always choose to close the bank earlier rather than later. Now public policy considerations lead the insurance agencies to keep some institutions operating even though they have negative net worth. The paper does suggest some means of dealing with this problem, but they involve maintaining a role for the government in the system. In fact, the paper assumes, as do most other discussions of this topic, that there will always have to be some role for the federal government if the system is to be credible. As the authors state: "the operational question is whether this participation [by the government] can be effectively limited to that of a residual guarantor with responsibility for management of the system . . . granted to private guarantors." This question is crucial to the desirability—not the feasibility—of private deposit insurance. The rationale for private deposit insurance is that it may allow a reduction of government regulation with a replacement by market forces. But if the government must retain a major role in the system, including regulatory powers, it is not clear that there is any benefit from adding a layer of private insurance on to an existing governmental system.

But it may be feasible to obtain some benefit from an increasing role for private insurance companies without their actually writing deposit insurance. The paper notes that "From the vantage point of the [depositor], insurance functions as a substitute for additional equity or subordinated debt." Suppose we require that all banks sell subordinated notes equal to, say, 5% of deposits to an insurance company. That additional cushion will protect depositors and the FDIC, thus enabling some reduction of regulatory constraints on the institutions. The insurance companies will appraise the relative riskiness of the subordinated notes available in the market, and hence market forces will increase the cost of capital to banks that operate in a risky manner. It appears, after all, that that is what is being sought when we attempt to devise a system of private deposit insurance.

There are a number of points in this paper that I wish I had time to praise or criticize. Given the lack of time, I can only emphasize that this paper represents an unusually perceptive analysis of the theoretical issues involved in substituting private depositor insurance for federal. No subsequent proposal for private deposit insurance will be able to ignore the issues raised in this paper.