Greenspan's Deposit Insurance Subsidy Argument Is Nonsense

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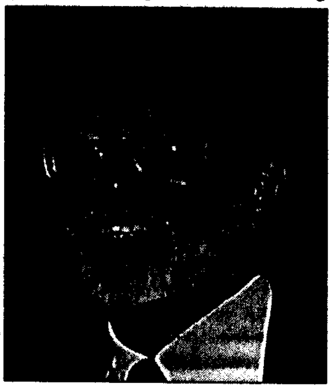
Federal Reserve Chairman Alan Greenspan frequently asserts that banks receive a deposit insurance subsidy. Therefore, he contends, they should exercise expanded powers only through a holding company regulated by the Fed.

In fact, there is no such subsidy nor are banks otherwise subsidized by a federal safety net. This assertion is merely part of the Fed's effort to protect its regulatory turf against the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and state insurance departments and to advance itself as the umbrella supervisor of the financial system.

Banking's supposed federal safety net consists of the Fed granting finality on payments flowing through it, discount window lending, and deposit insurance.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Granting payment finality creates an intraday overdraft risk for the Fed. However, through proper management, the Fed can hold this very short-term risk to an absolute minimum.

All Fed discount window loans must be fully collateralized. Further, loans made for extended periods must carry a penalty rate of interest, so no risk or subsidy attaches to these loans.

The Continental Illinois failure in 1984 illustrates this point: The Fed advanced $7 billion to Continental, and was repaid every penny, with interest. However, the FDIC, and therefore the nation's banks, suffered a $1.1 billion loss protecting Continental's depositors and other creditors.

Clearly, banking's entire safety-net risk is concentrated in deposit insurance. Bank deposit insurance, though, has not cost taxpayers a cent.

True, the S&L crisis cost taxpayers, banks, and healthy S&Ls $150 billion, but S&L insolvency losses were caused by disastrous Fed monetary policies and bad regulation. The excessively low interest rates the Fed engineered in the late 1960s and 1970s sparked an inflation that drove interest rates sky-high in the early 1980s, thereby revealing the folly of the S&Ls' government-encouraged maturity mismatching.

This year, the federal government will explicitly net about $2 billion from its safety net activities. This amount consists of the FDIC's net income and the value to the government of banks and thrifts' non-interest-bearing reserves less the Fed's regulatory costs.

Even in a crisis, banking poses no practical taxpayer risk. Interstate branching, prompt correction action, and depositor preference in liquidations should minimize bank and thrift insolvency losses.

The FDIC's regular pay-as-you-go assessments plus special assessments for protecting creditors in banks that are "too big to fail" has shifted to healthy institutions all losses the FDIC pays.

These provisions highlight the real subsidy problem that Mr. Greenspan artfully ignored — the cross-subsidy that flows from good banks and thrifts to the badly managed.

Rather than threatening taxpayers, banking regulators pose a major risk to banking's bottom line, for if regulators are negligent, healthy banks and thrifts will pay the tab. This is in addition to the excessive regulatory burdens they bear today.

Mr. Greenspan's assertion that there is a deposit insurance subsidy (some mistakenly call it a "gross subsidy") reveals a fundamental ignorance about insurance.

Insurances of all kinds spread risk by shifting a risk of loss from the insured to the insurer who also has assumed numerous similar risks.

Deposit insurance shifts to other insured institutions, through premium assessments, a bank or thrift's potential loss to depositors not borne by its stockholders.

By shifting away the risk of a loss, insurance permits the insured, whether a homeowner, a business, or a bank with deposit insurance, to operate with higher leverage than would otherwise be possible.

With any form of financial intermediation, increased leverage enhances an intermediary's competitiveness since equity capital is more expensive than deposits and other forms of debt. That is, by operating with the higher leverage that deposit insurance permits, banks and thrifts enjoy a more competitive cost of funds.

Finance companies operate with less leverage and therefore higher funding costs unless they utilize risk-spreading devices comparable to deposit insurance, such as third-party credit enhancements.

Deposit insurance's value to banks and thrifts is the cost of funds differential between having or not having that insurance. That value is substantial and it exceeds the government's cost of providing deposit insurance under present law. However, the excess of this value over the government's cost is not a subsidy — it represents the leveraging value inherent in any form of insurance.

The fact that banks and thrifts do not earn above-average returns on their capital suggests that competitive forces transfer the value of deposit insurance to bank customers.

Rather than acknowledging the legitimate risk-spreading value of deposit insurance, Mr. Greenspan makes his specious assertion that there is a deposit insurance subsidy.

This is a patently transparent attempt to convince Congress that it should continue to saddle banks with the holding company structure. Further, his unsubstantiated claim that holding companies best contain this non-existent subsidy is irrelevant.

For most banking companies, the holding company structure is less efficient than placing a bank at the top of the organizational pyramid. Further, interstate branching has made holding companies obsolete for branching purposes. Consequently, the Fed is peddling a product that few want. Congress should tell the Fed: No sale! ◇

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