

# **Banks Do Not Receive a Federal Safety Net Subsidy**

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# **Banks Do Not Receive a Federal Safety Net Subsidy**

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## **Executive Summary**

For several years, the Federal Reserve, and its chairman, Alan Greenspan, have argued with extreme forcefulness that banks benefit from a substantial, but apparently unquantifiable taxpayer subsidy. Mr. Greenspan contends that in order to minimize the competitive distortions caused by this alleged subsidy, expanded powers for banking companies should be exercised only through non-bank affiliates of bank holding companies regulated by the Fed and barred for operating subsidiaries of national banks regulated by the Treasury Department's Office of the Comptroller of the Currency.

The Fed cannot quantify the amount of this alleged subsidy because there is, in fact, no such subsidy. Instead, a subsidy of at least \$1.5 billion annually flows in the opposite direction, in the form of non-interest-bearing loans banks have been forced to make to the federal government through the Fed and the Federal Deposit Insurance Corporation.

What some contend is a federal subsidy to banks in fact is not, for two reasons. First, deposit insurance delivers genuine economic value to banks due to its inherent risk-spreading nature which is common to all insurances. That is, deposit insurance protects deposits against bank failure because, through the premium charged for it, deposit insurance effectively spreads bank insolvency risk over a far broader equity capital base than just the capital of the bank holding those deposits. Deposit insurance therefore permits each insured bank to utilize expensive equity capital more efficiently than it otherwise could; that is, a bank with deposit insurance can operate with higher leverage than it could without it. The fact that the federal government currently operates the deposit insurance system does not negate this inherent value of deposit insurance. Non-bank firms must, of necessity, operate with lower leverage because they do not have insolvency protection for their creditors comparable to deposit insurance.

Second, taxpayers do not subsidize federal deposit insurance because over the last decade Congress has made deposit insurance as risk-free as possible to taxpayers by creating mechanisms which impose all deposit insurance losses on the banking industry, even in circumstances far worse than the S&L crisis. Because of the reforms Congress enacted, deposit insurance is no longer simply a government guarantee, as it was during the S&L crisis -- it has been transformed into a genuine insurance mechanism which can stand on its own without federal backing. Ironically, these taxpayer safeguards have greatly magnified the highly undesirable cross-subsidy within deposit insurance which flows from sound, well-managed banks to poorly capitalized and badly run banks. Unfortunately, the existence of this cross-subsidy has been masked by Mr. Greenspan's false assertion that taxpayers subsidize federal deposit insurance. Worse, his false assertion has inflicted significant and possibly lasting harm on the banking industry by making it more politically vulnerable to the imposition of yet more social welfare obligations beyond those which already burden it, but not its non-bank competition.

Interestingly, this analysis of the subsidy argument reveals that non-banks, and specifically securities firms, receive a significant taxpayer subsidy -- free access to the Fed's discount window during times of economic duress. Arguably, permitting this access achieves

firms any more than the public good of federal deposit insurance would warrant a taxpayer subsidy for banks.

Although banks do not receive a taxpayer subsidy, the Fed's amazing success in propounding this fiction has raised the question of how best to contain the alleged subsidy. Careful analysis indicates that even if a subsidy existed, it would flow with equal ease to operating subsidiaries of banks and non-bank subsidiaries of holding companies. Therefore, whether there is a subsidy or not, there is no rationale for limiting the organizational flexibility of banks by requiring that certain activities be conducted only in non-bank subsidiaries of Fed-regulated holding companies. Mr. Greenspan's argument that the holding company structure better contains the fictional subsidy is entirely without merit.

## Introduction

Contrary to frequent assertions by Federal Reserve Chairman Alan Greenspan, banks do not receive a so-called federal "safety net subsidy," as this paper will demonstrate. Instead, banks pay all costs of banking's federal safety net, including the federal government's cost of regulating banks. What is alleged to be a safety net subsidy, specifically that banks can operate with higher leverage than non-banks, in fact represents the consequence of the risk-spreading nature of deposit insurance. That is, banks can operate with higher leverage ratios than their non-bank competitors because banks participate in, and pay for the entire cost of, a risk-spreading mechanism that safely permits higher leverage.

This paper will first explain what a federal safety net subsidy would be if banks did receive such a subsidy. It will then explain the structure of banking's federal safety net to demonstrate that any taxpayer risk, and therefore any subsidy flowing from this safety net, is concentrated in federal deposit insurance. The next portion of the paper will describe various actions Congress has taken over the last ten years to eliminate taxpayer risk from deposit insurance by imposing all of that risk on the capital of the entire banking system. The paper will then explain how deposit insurance works as a risk-spreading mechanism so as to permit higher leverage for banks insured by the Federal Deposit Insurance Corporation (FDIC). At the same time, as the paper will demonstrate, the banking industry pays what amounts to a subsidy to the federal government of at least \$1.5 billion annually. Unfortunately, as the paper will explain, federal deposit insurance has created an unhealthy cross-subsidy within the banking industry which flows from healthy, well-managed banks to weak, poorly managed banks. At the same time, large non-bank financial firms receive an important federal safety net subsidy in the form of free access to the Federal Reserve's discount window. Finally, the paper will conclude that while banks do not receive a federal safety net subsidy, if there were one it would be equally well contained in a bank-operating subsidiary structure as in a holding company-affiliate structure.

Two other points regarding this paper are in order. First, the term "banks" refers, unless otherwise indicated, to all FDIC-insured institutions, including savings-and-loans and savings banks. However, the term does not encompass credit unions. Second, the paper assumes that the alleged federal safety net subsidy ultimately is paid by taxpayers. It is highly unlikely that there is another source for such a subsidy.

### **What a Safety Net Subsidy Would Be If There Were a Subsidy**

The threshold question in the debate over whether or not banks receive a federal safety net subsidy is what would constitute a taxpayer subsidy to banks if a subsidy actually existed. That is, how would banks actually reap that subsidy? There appear to be four ways in which a taxpayer subsidy could be transmitted to banks -- direct payment of taxpayer funds to banks, using taxpayer funds to protect depositors and others from bank insolvency losses, using taxpayer funds to pay the cost of banking regulation, and higher interest rates on the federal debt because of the contingent taxpayer liability posed

by federal deposit insurance. None of these potential sources of a federal safety net subsidy exist, as will be discussed shortly. The absence of any subsidy is reinforced by the fact that the Fed has never quantified the dollar amount of this subsidy. As recently as April 28, 1999,

activities as a principal would lead to "greater federal subsidization" (Greenspan, 1999), he did not quantify the amount of that increased subsidy. Surely, if a subsidy existed, Fed economists could at least estimate its size.

### Direct payment of taxpayer funds to banks

The federal government does not directly subsidize banking activities by making explicit payments to banks. For example, the government does not pay banks to maintain branches in low-income communities nor does it subsidize banks operating in remote locations. Further, any services which the federal government purchases from banks are priced at competitive market rates.

### Using taxpayer funds to protect depositors in failed banks

Although the S&L crisis cost general taxpayers \$125 billion,<sup>1</sup> steps Congress has taken since then, notably the 1991 enactment of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), have effectively eliminated the risk federal deposit insurance poses to taxpayers. These protections are summarized below, starting on page 6, in the discussion of federal deposit insurance.

### Using taxpayer funds to pay the cost of federal banking regulation

Federal banking regulation cost almost \$1.7 billion in 1997;<sup>2</sup> figures are not yet available for 1998. The Office of the Comptroller of the Currency (OCC), the regulator of national banks, is supported entirely by examination and application fees paid by banks. The same is true for the Office of Thrift Supervision (OTS), the federal regulator of thrift institutions (savings-and-loans and savings banks). As will be discussed further below, the expenses and insurance losses of the FDIC are fully covered by deposit insurance premium assessments and interest earned on the fund balance of the FDIC's two deposit insurance funds, the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). The expenses of the Federal Financial Institutions Examination Council, the regulators' coordinating body, are charged to the regulatory agencies.

At the Fed, the income value of non-interest-bearing reserves which banks maintain on deposit at the Fed was approximately \$653 million in 1997,<sup>3</sup> or \$136 million more than the cost of the Fed's supervision and regulation activities in 1997. As is widely recognized, the present reserve requirement on checkable deposits is simply a tax on those deposits. The Fed does not use these reserves to execute monetary policy since it long ago elected to instead be an interest-rate signaler (Ely, 1997a). Although reserve balances are declining because of bank sweep accounts (average reserve balances declined 11% in 1998), the income value of reserve accounts should continue to exceed the cost of Fed supervision and regulation for the foreseeable future. Any shortfall, though, at the Fed will be more than covered by the FDIC's net income, as noted below in the discussion, starting on page 12, of the banking industry's forced loan to the FDIC.

### Increased cost of financing the federal debt

Although it cannot be proven, it is highly unlikely that the federal government's

contingent liability under federal deposit insurance has raised the cost of financing the federal debt, for two reasons. Arguably, any increase in this financing cost could be viewed as a subsidy to the banking industry. First, the federal government's debt has unambiguously been rated AAA for many years. In fact, Treasury securities, despite any contingent federal deposit insurance liability, are widely viewed as the closest thing to risk-free debt that exists anywhere in the world. Therefore, it is difficult to imagine that federal deposit insurance has raised yields on Treasury securities.

Second, as will be discussed below, starting on page 6, over the last decade Congress has made federal deposit insurance essentially risk-free to federal taxpayers. Any perceived cost advantage banks have in obtaining insured deposits therefore is a product of the soundness of banking's self-financed insurance safety net. Also, bank deposits appear to be a relatively cheap source of bank funding largely, if not entirely, because of the expense banks incur in gathering deposits through branch offices and in the substantial regulatory costs banks must pass through to their depositors.

### **The Structure of Banking's Federal Safety Net**

Banking's federal safety net has three components -- banks' ability to borrow at the Fed's discount window, the Fed's guarantee of payment finality on payments transmitted through the Fed, and federal deposit insurance. As a practical matter, if banks receive a safety net subsidy, it comes only through federal deposit insurance because the Fed operates the other two components of this safety net on a risk-free basis to itself and therefore to the taxpayer.

#### The Fed discount window

The Fed discount window does not provide banks with a safety net subsidy although it does provide banks, and especially small rural banks, with a very slight funding subsidy comparable to the funding subsidy that the Federal Home Loan Banks deliver to their members. For the 1992-98 period, discount window loans outstanding averaged \$208 million -- \$74 million for adjustment loans (used to meet reserve requirements and other short-term liquidity needs) and \$134 million for seasonal loans to small agricultural banks; for 1998, the comparable numbers were \$162 million, \$67 million, and \$95 million.<sup>4</sup> Given that the Fed's lending or discount rate for adjustment and seasonal loans is a below-market rate, this funding subsidy would equal approximately \$2 million annually if a market rate was one percent higher and \$4 million if it was two percent higher. Although indefensible, in the larger scheme of things, this is an extremely modest subsidy.

The Fed should not suffer any losses as a lender since it lends to banks only on a fully collateralized basis; acceptable collateral is specified in the Fed's Regulation A.<sup>5</sup> Further, because the Fed can be a very demanding lender, it can insist on substantial overcollateralization of its loans and can demand the posting of additional collateral should the posted collateral lose market value. Any losses the Fed did experience as a lender would be borne by taxpayers because these losses would reduce, dollar-for-dollar, the earnings the Fed sends back to the Treasury every year. Any loss the Fed experienced on its discount window lending would occur only because Fed officials failed to monitor the market value of the Fed's

loan collateral in a timely manner. Also, under Sec. 142 of FDICIA, the Fed could be liable to the FDIC in a failed bank situation for any increased loss to the FDIC as a result of the Fed failing to demand payment of outstanding discount window loans within five days after the failed bank became "critically undercapitalized." However, such a loss should be a fairly easy bullet for the Fed to dodge.

Therefore, because of its essentially risk-free nature and the modest amount lent, the Fed's discount window does not gift a safety-net subsidy to the banking industry. Even its funding subsidy, a few million dollars per year at most, is extremely modest compared to the funding subsidies provided by the Federal Home Loan Banks.

### The Fed's payment system

The Fed provides payment finality on interbank payments made through the Fed, thereby eliminating interbank credit risk for those banks which directly access the Fed's payment system. These interbank payments generally take the form of checks deposited in the Fed for collection from other banks, automated clearinghouse (ACH) payments, and Fedwire funds transfers. In effect, when the Fed grants payment finality to a bank for a payment the Fed has not yet collected from another bank, the Fed has assumed a credit risk on the bank upon which the payment was drawn while the payment is being processed through the Fed's payments system. However, this credit risk is extremely short-term, lasting just a few minutes to a few hours for any single payment. The Fed has recognized this payment system risk by establishing daylight overdraft limits; that is, a limit on the amount that a bank can be overdrawn at any point in time in its reserve or clearing account at the Fed. Further, the Fed can charge interest on intraday overdrafts; that interest effectively compensates the Fed for the intraday credit risk it assumes by providing payment finality at the time a payment is presented to it for collection.<sup>6</sup>

Operating in a real-time environment, the Fed can effectively eliminate its payment system risk in two ways. First, it can refuse to accept payment requests presented to it which are drawn on weak banks. Second, it can accept such payment requests only to the extent to which a weak bank has covered any intraday overdraft at the Fed by borrowing at the discount window on a fully collateralized basis. In other words, through proper, timely management, the Fed can eliminate its payment system risk and therefore any subsidy that direct access to the Fed's payment system would provide to the banking system. As a practical matter, the Fed has always operated its

payment system on a risk-free basis, which means that the Fed has not subsidized the banking system in this manner.

Contrary to the Monetary Control Act of 1980, which bars the Fed from subsidizing the priced services (principally collecting checks, processing ACH payments, and executing Fedwire transfers) it offers to banks, the Fed in fact does subsidize these services by using a portion of its annual "pension cost credit" to lower its service prices. In 1997 (the most recent year for which figures are available), the Fed recognized a pension cost credit of \$200.8 million.<sup>7</sup> While \$138 million of this cost credit was turned over to the U.S. Treasury, the Fed retained approximately \$62.8 million of this credit to subsidize its priced-services activities.<sup>8</sup> However, this subsidy is not a safety net subsidy. Instead, it represents a

conscious effort by the Fed to use funds that would otherwise go to the U.S. Treasury to gain a competitive edge, through lower prices, over private-sector providers of payment services.<sup>9</sup> An amendment to S. 900, the financial services modernization bill passed by the Senate on May 6, 1999, will bar the Fed from using any portion of its pension cost credit to subsidize its priced services activities.

### The Federal Reserve portion of the safety net poses no taxpayer risk

Clearly, Fed operations, and specifically its discount window lending and the operation of its payment system, are designed to operate on a risk-free, and therefore loss-free, basis. To the best of the author's knowledge, the Fed has never incurred a loss from a bank failure. The run on and subsequent failure of Continental Illinois in May 1984 best dramatizes the ability of the Fed to avoid losses in failed banks. Fed advances to Continental Illinois peaked at \$7.6 billion in August 1984 (Continental Illinois Corporation, 1984, p. 2), yet the Fed did not lose a penny on that loan, or at least the Fed has never admitted to any such loss, yet the FDIC spent \$1.1 billion<sup>10</sup> protecting depositors and other Continental creditors against any loss whatsoever. Clearly, losses incurred under banking's federal safety net are focused on federal deposit insurance and the FDIC.

## **Federal Deposit Insurance**

Federal deposit insurance for banks, which is offered exclusively through the FDIC, represents the third component of banking's federal safety net. Federal deposit insurance is a contingent liability of the federal government; as a practical matter, though, numerous safeguards Congress has enacted since the S&L crisis have eliminated any risk federal deposit insurance might otherwise pose to taxpayers.

Federal deposit insurance creates the potential for a taxpayer subsidy only to the extent that the FDIC incurs losses in protecting depositors of failed banks. If banks never failed or always failed without losses to the BIF or SAIF, then there would be no losses to be subsidized. Banks do fail, though, even in good times, and sometimes with substantial losses. However, those losses will not be borne, or in effect be subsidized, by taxpayers if they instead are paid by healthy banks through deposit insurance premiums. Despite suffering \$37.1 billion in losses from 1934 to 1997,<sup>11</sup> the BIF and its predecessor, the FDIC fund, have not received a single dollar of taxpayer assistance. Instead, all BIF/FDIC losses as well as FDIC operating expenses have been covered by deposit insurance assessments, which totaled \$46.4 billion through the end of 1997,<sup>12</sup> and earnings of the BIF/FDIC fund. Even the federal government's initial \$289 million capitalization of the FDIC was repaid in 1947 and 1948, with interest.<sup>13</sup> At the end of 1998, BIF had a fund balance (unaudited) of \$29.6 billion (Federal Deposit Insurance Corporation, 1998a, p.17). SAIF, the successor to the Federal Savings and Loan Insurance Corporation (FSLIC), which has had a comparable experience since 1989, reached an unaudited fund balance of \$9.8 billion at the end of 1998 (Federal Deposit Insurance Corporation, 1998a, p.17).

Stung by the S&L crisis, and its enormous cost to taxpayers, as well as by the commercial banking problems of the 1980s and early 1990s, Congress enacted numerous reforms which directly or indirectly have eliminated the taxpayer risk in federal deposit

insurance. These reforms were intended, and to date have performed, to minimize deposit insurance losses while ensuring that all such losses will be imposed to the maximum extent possible on banks which do not fail. By eliminating the taxpayer risk previously posed by federal deposit insurance, Congress transformed federal deposit insurance from a government guarantee program into a genuine insurance mechanism, albeit a mechanism with serious cross-subsidy problems discussed below in the section on mispriced deposit insurance premiums, which starts on page 13.

The seven principal reforms divide into two broad categories -- minimizing deposit insurance losses and imposing all deposit insurance losses on bank capital.

### Minimizing deposit insurance losses

Cross-guarantees among affiliated banks (1989) The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which launched the resolution of the S&L crisis and FSLIC's bankruptcy, included a "cross-guarantee" provision (Sec. 206, enacting 12 U.S.C. 1815(e)). This provision made all "commonly controlled" banks liable for the FDIC's share of an insolvency loss in any one of the commonly controlled institutions. That is, the FDIC experiences an actual loss in a failed bank only to the extent that it cannot recover its potential loss from affiliated banks of the failed bank. As a practical matter, the amount of this potential recovery is limited to the market value of the affiliated banks. Hence, for deposit insurance purposes, all banks in a multi-bank holding company or otherwise under common ownership or control are treated as if they were one bank for the purpose of absorbing at least some portion of the FDIC's share of a failed bank's insolvency loss. To some extent, the value of this provision to the FDIC has been diminished by interstate branching, which was authorized in 1994 (and is discussed on the next page). Nonetheless, it was an important first step which Congress took to minimize FDIC losses and remains an important loss-minimization tool for the FDIC.

Prompt regulatory action/least-cost resolution (1991) In many ways, prompt regulatory action (often referred to as prompt corrective action, or PCA) and least cost resolution (LCR), are the heart of FDICIA,<sup>14</sup> which Congress enacted on November 27, 1991. Together, PCA and LCR represent the most important tool the federal government has to minimize deposit insurance losses in banks which have sunk into insolvency. At the same time, they reflect a fundamental and understandable congressional distrust of the bank regulators in the aftermath of the S&L crisis and problems in the commercial banking industry. Briefly, regulations issued under the authority of PCA set trigger points in a bank's slide towards insolvency. These triggers are intended to force regulators to take timely corrective action in a failing situation or, barring a turnaround, to force the closure of a bank before it becomes insolvent. LCR is designed to minimize the FDIC's use of purchase-and-assumption transactions in failed bank situations because such transactions can protect the uninsured portion of deposits, which has the effect of raising the cost of a bank failure. Although not fully tested during a severe economic crisis, in theory PCA and LCR should minimize deposit insurance losses even during a crisis. A discussion of the workings of PCA and LCR lies beyond the scope of this paper.

Depositor preference in failed banks (1993) Although enacted as part of the 1993

budget reconciliation bill as a spending reduction measure and with no debate whatsoever over its deposit insurance implications, the depositor preference provision of the Federal Deposit Insurance Act<sup>15</sup> serves as a potentially significant legal device for reducing FDIC losses in failed banks. Briefly, depositor preference gives both insured and uninsured deposits in domestic branches of a bank a liquidation preference over deposits in that bank's foreign offices as well as all other general, unsecured claims on that bank. Consequently, general unsecured claims which are not domestic deposits will absorb all of a failed bank's insolvency loss before the first dollar of loss will be borne by domestic deposits, and specifically by the FDIC as the insurer of the insured portion of domestic deposits. Depositor preference already is playing a role in reducing the FDIC's loss in the relative handful of banks which have failed in recent years.

Interstate banking and branching (1994) Although intended primarily to improve the operating efficiency and customer service of commercial banks, the Interstate Banking and Branching Efficiency Act of 1994 greatly improved the safety-and-soundness of the banking system by permitting large banks to operate regionally or nationally. The banking problems in Texas and other states during the 1980s as well as the banking crisis of 1930-33, during which time 9,000 mostly small, single office banks failed (Federal Deposit Insurance Corporation, 1983, table on p. 41) were greatly aggravated by state and national banking and branching restrictions and prohibitions. It is highly unlikely that even a future regional banking crisis, such as that which struck the Southwest in the mid-1980s or the New England banking crisis of the late 1980s and early 1990s, would be as severe, in terms of deposit insurance losses, as those crises were.

### Imposing all deposit insurance losses on banks

Recapitalizing the deposit insurance funds Sec. 104 of FDICIA established the framework for building the BIF to a "designated reserve ratio" (presently 1.25% of insured deposits) and maintaining that ratio. FIRREA, which created the BIF and SAIF, established similar requirements for the SAIF. Under the guise of the designated reserve ratio, the FDIC was able to levy a substantial tax on banks to build the BIF and SAIF to a 1.25% reserve ratio. Although not used solely to build the BIF to a 1.25% ratio, the FDIC levied \$27.9 billion of premiums on BIF-insured institutions from 1990 to 1995 (Federal Deposit Insurance Corporation, 1997, p. 105). From 1991 to 1996, the FDIC levied \$8.5 billion of premiums, including \$5.2 billion in 1996, on SAIF-insured institutions to build that fund to a 1.25% ratio (Federal Deposit Insurance Corporation, 1997, p. 107). These huge assessments cannot be tapped to pay future deposit insurance losses, as is discussed in the next paragraph. Hence, they form a permanent investment base which generates the interest savings on financing the federal debt that provides much of the special subsidy discussed below, starting on page 12, which flows from the banking industry to the federal government.

Unlimited FDIC assessment power Of particular importance to taxpayers, Sec. 103 of FDICIA gave the FDIC a blank check, through the authorization of emergency special assessments, on the capital of all of the institutions insured by a particular fund to

quickly rebuild that fund to the designated reserve ratio should prior losses have driven that ratio below the designated minimum. This unlimited assessment power gives the FDIC the power to draw heavily on the capital of the banking industry to cover deposit insurance losses should cross-guarantees, PCA, LCR, and depositor preference fail to minimize those losses. To the extent that the FDIC has to draw upon its \$30 billion line-of-credit at the U.S. Treasury to meet short-term liquidity needs, those interest-bearing borrowings will effectively be repaid from future FDIC assessments.<sup>16</sup> At December 31, 1998, the book value of the equity capital of all FDIC-insured institutions was \$556.7 billion (Federal Deposit Insurance Corporation, 1998, p. 16), almost three times the amount of the insolvency losses suffered by federal deposit insurance since the S&L crisis first erupted in the early 1980s.

Special "systemic risk" or too-big-to-fail assessments In addition to the emergency special assessment powers of FDICIA's Sec. 103, FDICIA's Sec. 141 codified the concept of too-big-to-fail (TBTF) and provided the means to pay for it. Specifically, this systemic risk provision (the so-called "systemic risk exception") authorizes the Fed and FDIC, with the concurrence of the Secretary of the Treasury and the President, to declare a bank TBTF. The FDIC may then protect, if necessary, all the liabilities of that bank against loss in order to "avoid or mitigate" the "serious adverse effects on economic conditions or financial stability" if the bank were liquidated under FDICIA's LCR provisions. The systemic risk provision of FDICIA also authorizes the FDIC to levy one or more emergency special assessments on the other members of the insurance fund to which the failed TBTF bank belonged to cover the cost of protecting the failed institution's creditors. Because of this provision, healthy banks, not taxpayers, will bear the cost of protecting uninsured creditors of TBTF banks from any loss.

### **Federal Deposit Insurance Permits Higher Leverage, Which Is Not A Subsidy**

Integral to the contention that banks receive a deposit insurance subsidy is the argument that this subsidy permits banks to operate with higher leverage than non-bank institutions. Kwast and Passmore (1997, pp. 16-27) present substantial evidence that non-banks, with the possible exception of large investment banks, operate with less leverage than banks. They close the discussion of their leverage contention by opining that "these differences [in leverage ratios] are quite likely due, in substantial part, to the fact that banks have direct access to the federal safety net" (Kwast and Passmore, 1997, p. 27) without explaining the linkage between this direct access to the safety net, the subsidy the safety net allegedly provides, and the higher leverage banks enjoy. Interestingly, they ignore the fact that non-bank firms can access one important element of the safety net, the Federal Reserve discount window, as will be discussed below, starting on page 13. What is especially intriguing about the Kwast/Passmore paper is that it ignores an explanation as to why banks can safely operate with higher leverage -- the insurance value of deposit insurance -- that this author explained in the American Banker (Ely, 1997b) three months prior to the publication of the Kwast/Passmore paper.

#### All forms of insurance permit higher leverage

A central element in the subsidy debate is the indisputable fact that all forms of insurance permit an insured to operate with higher leverage than the insured could enjoy without insurance. That is, higher feasible leverage is an inherent byproduct of the

risk-spreading nature of any form of insurance. This statement holds true for businesses, which banks are, as well as for individuals. In effect, insurance prevents the bankruptcy of businesses and individuals who have partially financed their assets with debt if their assets suffer an insurance-covered decline in value which exceeds the insured's net worth. Viewed from another perspective, insurance is a credit enhancement device an insured obtains in exchange for a fee called an insurance premium.

A simple example will illustrate this crucial point. An individual with a net worth of \$100,000 purchases a home for \$200,000 that is partially financed with a \$160,000 mortgage. Having used \$40,000 of her net worth to make a down payment on the house, she has \$60,000 worth of other assets. Hence, she has total assets of \$260,000 which have been financed by a \$160,000 mortgage and her \$100,000 of net worth. If her home then suffers a \$150,000 uninsured fire loss, she will now have assets worth \$110,000 and a negative net worth of \$50,000 (assets of \$110,000 minus the \$160,000 mortgage). Personal bankruptcy will occur, which means the mortgage holder will incur a loss of at least \$50,000. The risk of this type of loss is precisely why lenders insist that borrowers insure mortgaged assets for at least the amount of the mortgage. Consequently, a person who cannot obtain property insurance cannot leverage herself as highly as someone who can obtain such insurance. In effect, insurance exists not just to protect the net worth of the insured, but equally important to protect lenders against loan losses. In the context of this paper, a depositor is a lender to a bank.

Insurance works properly, from the perspective of ensuring insurer solvency, if the risks of loss it has assumed are diversified sufficiently; insurance premiums are priced properly so as to cover the insurer's losses, operating expenses, and profits (thereby deterring moral hazard on the part of insureds); and the insurer has enough net worth of its own to absorb extraordinarily high or unanticipated losses and pricing errors. In effect, insurance pools the risk of loss of many insureds in return for a premium. Consequently, by using insurance to shift the risk of a substantial loss to an unrelated party, an insured can own more assets than she otherwise could own since her net worth will not become negative if she suffers an insured loss. Put another way, an insurance contract is an option contract which give the insured an option on its insurer's net worth and loss reserves should the insured suffer an insured loss. An insurance premium therefore is the price of that option contract.

### Insurance theory applied to deposit insurance

This theory of insurance, which reflects the reality of insurance, is applicable to all types of financial institutions. The creditors of banks and insurance companies are, to some extent, protected by insurance mechanisms. The creditors of other types of financial firms, such as investment banks and finance companies, generally speaking do not enjoy similar insurance protection.<sup>17</sup> Therefore, all other things being equal, firms with insurance which protects their creditors against loss can operate with greater leverage than firms without that type of insurance. Claims on insurance companies are protected by state guaranty funds; a discussion of these funds lies beyond the scope of this paper. Instead, the balance of this paper will focus only on federal deposit insurance and the protection it provides to bank creditors, specifically depositors.

Although deposit insurance is characterized as protecting depositors, or at least the

first \$100,000 of a depositor's balance in a bank, against loss, in actuality federal deposit insurance works in a slightly different manner. A bank fails because it becomes insolvent; that is, it has a negative net worth because the book value of its liabilities exceeds the market value of its assets. A bank becomes insolvent, and therefore a failed bank, when asset losses and operating losses (current expenses exceed current income) consume any positive net worth it had. When the FDIC takes over a failed bank, it places it in a receivership. The FDIC then advances to the receivership sufficient funds to ensure that insured deposits are made whole, either through a direct payment to depositors or a transfer of the insured deposits to another bank. The FDIC then assumes, under the law of subrogation, a claim on the failed bank's receivership in proportion to the amount of insured deposits it protected to the total amount of domestic deposits. The payment the FDIC makes into the failed bank's receivership is functionally equivalent to the payment an insurance company makes to a homeowner who has suffered a fire loss or, if so specified in the insurance contract, to the holder of the mortgage on the home.

Insured deposits permit a bank to operate with higher leverage than it could without deposit insurance because deposit insurance shifts to other banks, through FDIC premium assessments, the bank's insolvency risk that otherwise would be borne by the

insured deposits. Unlike a money market mutual fund, though, a bank cannot operate with infinite leverage, that is zero capital. Instead, it must hold some capital which effectively operates as an insurance deductible that provides some insolvency risk protection for the FDIC and therefore for other banks. The fact that most banks today are not paying explicit premiums to the FDIC does not negate the fact that they are paying for their FDIC insurance, as will be discussed below, starting on the next page. This insolvency risk protection potentially extends to all liabilities in banks that most likely are TBTF although the uncertainty as to which banks are TBTF (the so-called "constructive ambiguity" favored by regulators) undermines the credit-enhancing value of TBTF protection.

Like any insurance entity, the FDIC must have sufficiently dispersed risks in order to be a sound, viable insurance mechanism. The FDIC is a very viable insurer given that it insured 8,554 banking companies at the end of 1998 (Federal Deposit Insurance Corporation, 1998b, p. 62).<sup>18</sup> The fact that the FDIC operates two insurance funds, the BIF and the SAIF, does not threaten the FDIC's viability as an insurer since Congress intends to merge the two funds and in any event would quickly merge them if one of them began to suffer high losses.

The largest individual FDIC insurance risk, BankAmerica, accounted for just 5.9% (\$163.5 billion) of the FDIC's insured deposits at September 30, 1998 (the latest date for which this data is available).<sup>19</sup> BankAmerica's insured deposits equaled just 29.6% of the total capital of FDIC-insured banks on that date (\$163.5 billion/\$556.7 billion). Given its size, the diversity of its assets, and its geographical spread, in the extremely unlikely event that BankAmerica should become insolvent, the FDIC's loss in resolving its subsidiary banks would be a tiny fraction of their insured deposits. For example, if BankAmerica incurred an insolvency loss equal to 5% of its liabilities, it would cost the FDIC \$8.2 billion (\$163.5 billion x .05) to protect BankAmerica's insured deposits against any loss; that amount equals just 1.5% of total bank capital (\$8.2 billion/\$556.7 billion). If BankAmerica were declared to be TBTF, which almost certainly would be the case, a loss equal to 5% of the total amount of liabilities to be protected

might be as high as \$27-\$28 billion, or approximately 5% of total bank capital. While enormous (and reflective of massive regulatory failure), a loss of that magnitude nonetheless could be borne entirely by the banking system.

Creditors of a non-bank financial firm operating without creditor insurance do not have a third-party standing by to make them whole if the firm becomes insolvent. Therefore, creditors of such a firm can look only to the net worth of the firm itself to protect them against insolvency. Accordingly, without that third-party protection, creditors properly insist that an uninsured firm operate with less leverage. However, there is nothing to prevent non-bank financial firms from establishing insurance mechanisms comparable to deposit insurance if their managements desired to operate with higher leverage.

### **The Bank Safety Net Actually Subsidizes the Federal Government**

Contrary to Mr. Greenspan's assertion that federal deposit insurance provides banks with a federal taxpayer safety net subsidy, the reverse is true -- banks effectively provide a special subsidy to the federal government and hence to taxpayers. This subsidy takes three forms -- two financial and one non-financial.

#### Banks' low-interest-rate loans to BIF and SAIF

The Federal Deposit Insurance Act effectively bars BIF and SAIF from dropping below a designated reserve ratio, which the FDIC Board has set at 1.25% of insured deposits. That is, if the fund balance in the BIF or the SAIF drops below 1.25% of insured deposits, either because of deposit insurance losses or growth in the total amount of insured deposits, then the FDIC Board of Directors must adopt a recapitalization plan for that fund. Key to raising a fund above a 1.25% reserve ratio is levying higher deposit insurance premium assessments on the members of that fund. This recapitalization requirement effectively means that the entire fund balance below the 1.25% requirement is not available to absorb deposit insurance losses, except over the very short term. In effect, then, the required reserve balance in each fund represents what is tantamount to a forced, low-interest-rate loan from the banking industry to the federal government. Banks extended that loan to the federal government through the high deposit insurance assessments they paid in the early and mid-1990s that built the BIF and SAIF to their 1.25% reserve ratios. These premium payments constituted a permanent loan to the federal government because the FDIC is "on budget,"<sup>20</sup>

A portion of the interest on this loan, which accrues to the FDIC as income earned on its portfolio of Treasury securities, pays for FDIC losses and expenses in excess of its deposit insurance premium assessments and other sources of income from outside the federal government. The portion of its interest income the FDIC spends effectively constitutes interest banks earn on the forced loan. That interest, which banks never collect, in turn, is in lieu of making cash premium payments to the FDIC.

The unspent portion of the FDIC's interest income on its Treasury securities represents the net income value to the federal government of the banking industry's forced loan. Banks receive absolutely nothing in return for this foregone income. In 1997, this loan

lowered the cost of financing the federal debt by approximately \$1.4 billion;<sup>21</sup> 1998 figures are not yet available. If Congress had put the FDIC on a pure pay-as-you-go financing basis, banks would not have had to pay heavy premium assessments to build the essentially untouchable portion of the BIF and SAIF fund balances. That portion, at the designated reserve ratio of 1.25%, reached \$35.6 billion at the end of 1998.<sup>22</sup>

Arguably, the banking industry delivers another \$800 million annually to federal taxpayers in the form of the interest banks pay on the FICO bonds issued during the 1987-89 period to finance a limited disposal of failed S&Ls. This interest is paid entirely by a special assessment on bank and S&L deposits. Because the S&L crisis was rooted in numerous failed public policies reaching back to the 1930s (Ely and Vanderhoff, 1991), the case can be made that FICO bond interest should be paid from general taxpayer funds rather than with a special assessment on bank deposits.

### Banks' non-interest bearing reserves

As noted on page 2, the income value of required reserves actually on deposit at the Fed exceeded the Fed's bank supervision expenses by \$136 million in 1997. Given that banks probably hold more vault cash than they would if interest was paid on reserves on deposit at the Fed, the excess of the Fed's income on required reserves over Fed supervision and regulation expenses is somewhat higher. However, reserves on deposit at the Fed have been dropping due to sweep accounts, so the income value of these reserves has been declining and would disappear if the Fed opted to pay interest on reserves (contrary to popular belief, the Fed is not explicitly barred by law from paying interest on reserves).<sup>23</sup> The time may arrive when the Fed's supervision and regulation expenses will exceed the income value of required reserves. However, even if the Fed held no non-interest-bearing reserves, its supervision and regulation expenses would be substantially less than the interest savings the federal government enjoys by virtue of the forced loan the banking industry has made to the FDIC, and hence to the federal government.

### Non-financial subsidies

Because Congress views federal deposit insurance as a great benefit to the banking industry, it has imposed social welfare obligations on banks that effectively save the federal government substantial sums. It lies beyond the scope of this paper to quantify those sums. The Community Reinvestment Act (CRA) is one obvious obligation. While there is great debate over whether banks make or lose money when meeting their CRA obligations, it is highly unlikely that CRA lending and service obligations earn the target rates of return that banks set for other products and services, especially when considering the substantial administrative costs banks incur in complying with the CRA. Other laws, such as the Bank Secrecy Act, which impose obligations on banks but not on other types of financial institutions, effectively represent a special tax on banks and therefore a subsidy to the government.

Adding it all up, the banking industry effectively provided a cash subsidy to the federal government of \$1.5 billion in 1997 plus payment of FICO interest and an incalculable amount of social welfare services, specifically in the form of CRA lending.

## **Federal Deposit Insurance Creates An Undesirable Cross-Subsidy Within Banking**

While banks do not, contrary to Mr. Greenspan's assertion, receive a federal safety net subsidy, federal deposit insurance has created a highly undesirable cross-subsidy within the banking industry which flows from healthy, well-managed banks to weak, poorly managed banks. This cross-subsidy takes three forms -- mispriced

deposit insurance premiums, excessive capital requirements for low-risk assets and well-managed banks, and excessive regulatory compliance costs.

### Mispriced deposit insurance premiums

Although it may seem odd to contend that healthy banks pay too much for their deposit insurance while weak banks pay too little given that almost 95% of the banks will pay no deposit insurance premium for the first half of 1999,<sup>24</sup> that in fact is the case, for this reason: The annual income foregone by banks on the deposit insurance premiums they paid to the FDIC to build the BIF and SAIF to a 1.25% reserve ratio, as discussed above, effectively is an implicit deposit insurance premium. Assuming banks could earn a 6% yield on this forced loan to the government, this foregone income is equivalent to almost a 6 basis point deposit insurance premium.<sup>25</sup> Hence, effective premiums for FDIC-insured deposits range from 6 basis points to 33 basis points since explicit premium rates presently range from zero to 27 basis points. In the author's opinion, based on his substantial research on the pricing of deposit insurance, this premium range is too narrow. The safest banks should pay no more than two basis points for insurance of all of their deposits while the riskiest banks should pay as much as 70-100 basis points.

The very serious problem caused by mispriced deposit insurance premiums is that they do not deter bad banking while also causing a misallocation of credit. Thus, the pernicious nature of mispriced deposit insurance reaches far beyond banks to the functioning of the entire economy, as became evident in the aftermath of the S&L crisis and the commercial banking difficulties of the 1980s and early 1990s. Unfortunately, the very real problem of the cross-subsidy within the banking industry caused by mispriced deposit insurance has been masked by the debate over whether or not banks, taken as a whole, receive a federal safety net subsidy.

The FDIC itself has acknowledged the shortcomings of its premium rate structure. Earlier this year, it considered charging a higher premium rate to as many as 573 banks, almost all of which did not pay any premium in 1998. The premium increase would have been levied on banks with CAMELS ratings of 3, 4, or 5 for bank management or asset quality (Barancik, 1999a) However, in response to a strong negative reaction to this proposal, the FDIC quickly announced that it was backing off from its initial proposal, having "decided to revise and delay until next year a plan to make more institutions pay for deposit insurance" (Barancik, 1999b). This retreat by the FDIC does not negate the fact that deposit insurance premiums are underpriced for riskier banks. The FDIC's problem is that as a government monopoly it cannot properly price deposit insurance premiums because prices can be properly established only in private, competitive marketplaces where both buyers and sellers, or insureds and insurers, have a choice as to whom they do business with.

### Excess capital requirements

Implicitly acknowledging that neither government banking regulation nor government pricing of deposit insurance will prevent unwise banking, Congress effectively mandated the Basle risk-based capital standards with regulations which tie prompt regulatory action, discussed above, to various measures of bank capital. Yet like FDIC insurance premiums, risk-based capital standards only very crudely reflect the actual riskiness of bank assets. This is particularly evident for loans to private-sector firms where no distinction in capital requirements is made between firms which are AAA-rated and those which have a junk bond status. Worse, capital ratios have been set high enough to minimize banking failures caused by a combination of inept management and regulatory failure,<sup>26</sup> which means that capital ratios are too high for well-managed banks. Undifferentiated capital requirements for private-sector credit risks, coupled with the inability of regulators to sufficiently differentiate good banking from bad in establishing risk-based deposit insurance premiums, are the principal reasons why banking has steadily lost market share as a channel of financial intermediation. In effect, regulatory inefficiencies have created substantial regulatory arbitrage opportunities which financial services entrepreneurs, utilizing electronic technology, have increasingly capitalized upon, at banking's expense.

### Excess regulatory compliance costs

Because of the regulatory shortcomings cited above and congressional distrust of the competency of the banking regulators, as FDICIA effectively proclaimed, Congress and the banking regulators have geared regulatory compliance burdens to the lowest common denominator in banking; that is, the poorly managed banks which are most likely to fail. This compliance burden is made worse by the inherent, one-size-must-fit-all nature of government banking regulation. This burden, which imposes higher operating costs on banks as well as regulatory straitjackets which impair the managerial flexibility of bank managers, further harms banking's competitiveness. All of these costs are borne by banks and are in no way subsidized by the federal government.

## **Large Non-Bank Financial Firms Receive An Implicit Safety Net Subsidy**

While banks pay for the entire cost of their federal safety net, as demonstrated above, large non-bank financial firms do not pay for their federal financial safety net, which is the ability to borrow at the Fed's discount window in "unusual and exigent circumstances."<sup>27</sup> Although the Fed has not lent in such circumstances for at least fifty years, it can lend to a large insurance company or investment banking firm facing severe liquidity problems. The importance of this standby lending authority for the Fed was evidenced by a little-noticed provision in FDICIA (Sec. 473, Emergency Liquidity) which effectively broadened the types of collateral which the Fed could accept in lending to non-bank firms to include marketable securities. This amendment reportedly was sparked by the liquidity problems some securities

firms faced in the aftermath of the 1987 stock market crash. The report accompanying the Senate version of FDICIA made clear that this amendment to 12 U.S.C. Sec. 343 was intended to make it easier for the Fed to lend to temporarily illiquid investment banking firms.

Unpublished reports also indicate that there have been times, specifically in the mid-1970s and the late 1980s, when insurance companies suffering liquidity problems approached the Fed about borrowing at the discount window. According to these reports, the Fed did not lend to these insurers, but that does not mean the Fed could not have lent to them. That insurers occasionally face liquidity crises illustrates one of the great weaknesses of the state guaranty funds for insurers -- the lack of an equivalent to the Fed's discount window.

Another close call for the Fed may have been Long Term Capital Management (LTCM). Although the New York Fed did lean on LTCM's principal creditors to provide additional liquidity to LTCM during its late-summer crisis last year, had that liquidity not been forthcoming, the Fed might have been forced to lend directly to LTCM in order to prevent a liquidity freeze-up in the global capital markets.

While the Fed theoretically would demand sufficient collateral when lending to a non-bank to protect itself against any loss, there is the danger that the Fed could not obtain enough collateral fast enough if the market value of the pledged securities was falling rapidly, as occurred during the 1987 stock market crash and again last summer following Russia's domestic debt default and LTCM's subsequent problems. This collateralization problem is compounded by the fact that most marketable securities of investment banking firms already have been pledged as collateral for the loans financing the purchase of those securities. In such a case, the Fed can only obtain a junior, and very thin, lien on such securities. Consequently, the Fed's risk of loss on discount window lending to non-bank firms may be much greater than it is on loans to banks which have substantial unobligated assets. Far worse in the case of non-bank firms, the Fed does not have an FDIC to look to for a bailout. As the Continental Illinois caper discussed on page 5 so clearly illustrates, the Fed can hide behind the FDIC when lending to a troubled bank. Sec. 142 of FDICIA further exaggerated this difference by limiting the length of time the Fed can lend to a troubled bank;<sup>28</sup> no comparable limit applies to non-bank discount window loans.

Non-bank financial firms which have legal access to the Fed's discount window do not have to pay a commitment fee in advance for that right of access nor has Congress established an after-the-fact mechanism, comparable to the FDIC's unlimited assessment powers, to assess surviving non-bank financial firms for any losses the Fed might incur in lending to non-bank firms. The absence of a commitment fee and assessment power effectively has gifted non-bank financial firms with a valuable federal financial safety net subsidy that has been denied to banks through their forced participation in an unsubsidized federal deposit insurance scheme. Arguably, a public good -- systemic stability -- flows from non-bank access to the discount window. However, that good does not warrant this subsidy any more than the public good of federal deposit insurance would warrant a taxpayer subsidy for banks.

### **If There Were A Bank Safety Net Subsidy, The Operating Subsidiary**

## **Structure Would Be Preferable to the Holding Company Structure**

As should be clear by this point, banks do not receive a federal safety net subsidy financed by taxpayers. Consequently, it should be a moot question as to whether the "op-sub" or the "holding company" structure of a banking organization can better contain a safety net subsidy. Unfortunately, this is not a moot question because of the amazing success Mr. Greenspan has had in promoting the fiction that banks receive a safety net subsidy. Therefore, the balance of this paper will examine the containment issue.

### Organizational differences underlying the op-sub debate

The op-sub organizational structure is one in which a banking company conducts what have traditionally been viewed as non-bank activities in an operating subsidiary of the bank; hence, the term op-sub. Notable among these non-bank activities are securities and insurance underwriting and brokerage. An op-sub, because it is owned by, and therefore is capitalized by, its parent bank, is subject to the regulatory oversight of the bank's regulator. In effect, the op-sub's equity capital, and therefore its capacity to absorb losses, flows from the bank's owner or owners through the bank to the op-sub.

Under rules proposed by the OCC, for the purpose of measuring a national bank's compliance with its regulatory capital requirements, a bank's equity capital investment in an op-sub must be fully deducted from the bank's capital. This deduction will eliminate any double-counting of capital and therefore any "double-leveraging" whereby debt of the parent is counted as equity capital in a subsidiary. Some degree of double-leveraging is still evident in capital arrangements between bank holding companies and their subsidiary banks, but not to the extent it once was. Still, the OCC's proposed rule represents a more conservative approach to op-sub capitalization than now governs the capitalization of banks by Fed-regulated bank holding companies.

In the holding company structure, non-traditional activities, specifically securities and insurance underwriting, are conducted in a direct subsidiary of the bank holding company. Therefore, such a subsidiary is a side-by-side, non-bank affiliate of the bank. That is, the bank and its non-bank affiliate have a common parent, which is regulated by the Fed as a bank holding company. The capital invested in the non-bank affiliate comes from the holding company, possibly with some degree of double-leverage. This structural alternative is referred to as the non-bank affiliate structure.

In addition to its equity capital investment, a bank can engage in other types of financial transactions with an op-sub, specifically lending to it or buying assets from it. Likewise, a bank can engage in similar transactions with a non-bank affiliate. In the latter case, Sec. 23A and 23B of the Federal Reserve Act limit the financial dealings between a bank and its non-bank affiliates; the OCC has proposed to apply the same restrictions to dealings between a bank and its op-sub. Therefore, the op-sub debate focuses on equity capital issues and not on debt or other types of financial transactions.

### Greenspan's safety net subsidy assertion

Mr. Greenspan, with almost no support outside of the Fed, asserts that banks receive

a safety net subsidy which banking companies can use to greater competitive advantage in the op-sub structure than in an affiliate structure. The fact that the OCC becomes the key banking regulator of a banking company opting for the op-sub structure while the Fed is the key banking regulator of a banking company electing the affiliate structure has no bearing, of course, on Mr. Greenspan's position in this debate.

There are two sequential pieces to Mr. Greenspan's safety net subsidy assertion. First, he contends that banks generate "subsidized equity capital." Apparently, based on a conversation the author had with a Fed economist familiar with Mr. Greenspan's thinking on this subject, subsidized equity capital represents the above-market rate of return banks earn on their equity capital by virtue of their safety-net access. There apparently are two sources for this additional rate of return.

The first source is that banks can lower their weighted average cost-of-funds by operating on a more highly leveraged basis than non-banks. This favorable cost-of-funds differential generates the additional return on equity that banks supposedly earn. It is true that banks can operate on a more highly leveraged basis than non-banks, but that advantage does not constitute a taxpayer subsidy. Instead, as was explained above, it represents the insurance value of any form of insurance. As noted above, if non-banks want to capture the risk-spreading benefit of insurance, they should create private insurance vehicles comparable to federal deposit insurance. As the author has explained in numerous fora, the cross-guarantee concept can be utilized to privatize bank deposit insurance and can be broadened to insure the liabilities of non-bank firms.<sup>29</sup>

The second source of above-market returns that banks supposedly earn stems from the federal government's guarantee of the FDIC's insurance obligation. Because of this guarantee, Mr. Greenspan contends, interest rates on bank deposits do not reflect a sufficient FDIC insolvency risk premium; that is, depositors would demand higher interest rates if the FDIC's insurance obligations were not federally guaranteed. Presumably this absence of an FDIC risk premium extends to the non-deposit liabilities of TBTF banks implicitly protected under the FDICIA systemic risk exception discussed above. However, there is no need for such a risk premium because the congressional reforms discussed above, starting on page 6, have essentially eliminated the FDIC insolvency risk.

The author readily agrees that deposit insurance is mispriced on a bank-by-bank basis, and grievously so in some cases, but the FDIC's unlimited assessment powers, which underpin the substantial cross-subsidy in deposit insurance pricing discussed above, readily trump the effect of the bank-by-bank mispricing of federal deposit insurance. That is, while some banks may benefit competitively for a time by being undercharged for their deposit insurance, eventually their sins will sink them, as we saw most recently in the BestBank failure.<sup>30</sup> Over time, though, the competitive damage of mispriced deposit insurance falls most heavily on the stronger banks which are hurt by

the overpriced deposit insurance premiums they pay, excessive capital requirements, and the regulatory burdens discussed above. Hence, while mispriced deposit insurance and banking regulation adversely distort the financial marketplace, the net effect of these distortions is far more detrimental than helpful to well-managed banks.

The second sequential piece of the Greenspan assertion is that having once captured extraordinary profits, thereby creating subsidized equity capital, banks can then more easily downstream that subsidized capital into op-subs than it can funnel that capital up to the bank's parent holding company, which would then invest that capital in non-bank affiliates. However, that argument simply does not wash because it is just as easy, given the tax neutrality of moving earnings around within a banking company, for the management of the banking company to invest bank earnings downstream into an op-sub as it is to dividend bank earnings up to the holding company for reinvestment in a non-bank affiliate. This equality will be strengthened by the OCC's proposed rule to require that all capital a national bank invests in an op-sub be deducted from the bank's capital for regulatory purposes.<sup>31</sup>

### Other arguments favoring the op-sub structure

Other arguments favor the op-sub structure over the non-bank affiliate structure, including the inherently greater operating efficiency of op-subs. Also, op-subs will strengthen banks, if the 100% capital deduction rule is in place, while non-bank affiliates could harm affiliated banks, particularly if the corporate veil between a bank and a non-bank affiliate can be pierced if the affiliate becomes insolvent. These arguments lie beyond the scope of this paper. However, an article by Longstreth and Mattei (1997) does an excellent job of demonstrating the legal superiority of the op-sub structure.

### **Conclusion**

The contention that banks receive, and therefore benefit competitively, from a federal safety net subsidy, is simply false. There is no subsidy because banks are subject to FDIC assessments which will pay for the full cost of the banking industry's safety net even in circumstances far worse than the S&L crisis. Further, various reforms enacted by Congress over the last decade have so dramatically reduced the potential for such a crisis that the reoccurrence of a crisis of that magnitude would represent unconscionable regulatory failure, partly by the very agency which argues that banks enjoy a federal safety net subsidy.

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## **Endnotes**

1. Author's calculation.

2. These costs, which totaled \$1.692 billion, break down by agency as follows: Federal Reserve System -- \$517 million; Federal Deposit Insurance Corporation (including administrative costs of

the deposit insurance funds) -- \$677 million; Office of the Comptroller of the Currency -- \$350 million; Office of Thrift Supervision -- \$148 million.

3. Reserves on deposit at the Fed in 1997 (excluding compensating balances for services provided by the Fed) averaged \$10.792 billion (calculated from the monthly Federal Reserve Bulletin, Table A6). The average yield on the Fed's securities portfolio in 1997 was estimated to be 6.05% (calculated from Board of Governors of the Federal Reserve System (1997), Statistical Tables 6 and 14).  $\$10.792 \text{ billion} \times .0605 = \$653 \text{ million}$ .

4. Calculated from data published in the monthly Federal Reserve Bulletin, various issues, Table 1.12, "Reserves and Borrowings."

5. Codified as 12 CFR 201.

6. It is not necessary for the Fed to include a cost-of-funds element in its intraday interest rate since it pays no interest to banks which accumulate positive intraday account balances at the Fed.

7. Board of Governors of the Federal Reserve System (1997), Pg. 288, Table 6, footnote 1.

8. Ibid., p. 264, footnote 2 to the financial statements for priced services provided by Federal Reserve banks.

9. The pension cost credit is describe more fully in a report by the author, titled "An Analysis of the Fed's Priced Services Activities," appended to testimony by Mr. Eric Roy, on behalf of the Association of Bank Couriers (Committee on Banking and Financial Services, 1997, pp. 249-250). This report also discusses other ways in which the Fed effectively utilizes taxpayer funds to subsidize the services which it provides to banks.

10. This estimate was obtained in a March 31, 1999, telephone call to the Division of Finance at the Federal Deposit Insurance Corporation.

11. Federal Deposit Insurance Corporation (1997), Table on Recoveries and Losses for All Cases, p. 104.

12. Ibid., Table of Income and Expenses, p. 105.

13. Federal Deposit Insurance Corporation (1980), p. 299, Table 127, Footnote 3.

14. Prompt Regulatory Action constitutes Subtitle D of Title I of FDICIA (Sec. 131-133) while Least-Cost Resolution follows in Subtitle E (Sec. 141-143).

15. Depositor preference was enacted as Sec. 3001 of Public Law 103-66 and is codified as 12 U.S.C. §1821(d)(11).

16. This line of credit is authorized by 12 U.S.C. Sec. 1824(a). In addition, Sec. 1824(b) authorizes the FDIC to borrow from the Treasury Department's Federal Financing Bank.

Sec. 1824(c) governs the repayment schedule for any such borrowings. Presumably, the interest rate on these borrowings will not be less than Treasury's borrowing rate given that, in setting the interest rate on Treasury loans to the FDIC, the Secretary of the Treasury will take "into consideration current market yields on outstanding marketable obligations of the United States of

comparable maturity." This provision in Sec. 1824(a) should bar any taxpayer subsidy to banks through this borrowing channel. Given the capital strength of the banking industry today, this line of credit could safely be canceled.

17. One exception: the Securities Investor Protection Corporation (SIPC), which is a creature of the federal government. It protects the cash and securities account balances of customers of insolvent broker/dealers against fraud, up to statutorily specified limits.

18. Although there were 10,461 FDIC-insured banks at the end of 1998 (Federal Deposit Insurance Corporation, 1998b, p. 63), the cross-guarantee provision of FIRREA discussed on page 6 effectively consolidates the banking industry into a smaller number of institutions for deposit insurance purposes.

19. Calculated from call reports filed with the FDIC by BankAmerica's ten subsidiary depository institutions.

20. The FDIC is "on-budget" for this reason: for the purpose of calculating the federal government's revenues, spending, and therefore its annual surplus or deficit, the FDIC's revenues from outside the government, such as the premiums it collects, count as federal revenues while its cash outlays count as federal spending. It is this inclusion of the FDIC's revenues and spending in the government's financial statements which makes the FDIC an on-budget federal agency. The interest the FDIC earns on its portfolio of Treasury securities does not count as federal revenue because it is merely a bookkeeping transfer within the federal government, from the Treasury to the FDIC.

21. BIF and SAIF combined net income of \$1.918 billion (\$1.438 billion for BIF plus \$480 million for the SAIF) for 1997 minus a non-cash reversal of prior years' loss provisions of \$506 million equals \$1.412 billion.

22. Total insured deposits of BIF and SAIF equaled \$2.85 trillion at the end of 1998 (Federal Deposit Insurance Corporation, 1998a, p. 17). 1.25% of that amount equals \$35.63 billion.

23. According to several observers on the scene at the time, in 1978, when interest rates were rising, the Fed proposed to pay interest on required reserves so as to arrest a decline in Fed membership as state-chartered banks dropped their Fed membership. Because the Federal Reserve Act does not specifically bar the Fed from paying interest on reserves, the Fed opined that it could pay that interest. However, members of the House and Senate Banking Committees strongly opposed this proposal, partly because payment of interest on reserves would have added substantially to the federal budget deficit. The banking committees reportedly backed up their position with a legal opinion from the Congressional Research Service of the Library of Congress stating that the Fed did not have statutory authority to pay interest on reserves; the author has not yet located that document. Faced with this extremely negative congressional reaction, the Fed backed off from its proposal. Congress later solved the Fed's membership problem by mandating, in the Monetary Control Act of 1980, that all depository institutions maintain reserves at the Fed regardless of whether they belong to the Fed. Congress's views in 1978 were set forth in a June 5 letter to then Fed Chairman G. William Miller from Henry S. Reuss, then chairman of the House Banking Committee, and William Proxmire, then Chairman of the Senate Banking Committee, and in a June 28 letter from Reuss to Miller.

24. For the first semiannual assessment period in 1999, 95.0% of all BIF-insured institutions will not pay an insurance premium while that will be the case for 93.4% of all SAIF-insured institutions. Just eleven FDIC-insured institutions will pay the highest premium rate of 27 basis points (Federal Deposit Insurance Corporation, 1998a, p. 19).

25. FDIC-insured deposits equaled 74.7% of total domestic deposits at the end of 1998 (\$2.85 trillion/\$3.814 trillion), as calculated from Federal Deposit Insurance Corporation (1998a), pp. 4, 16, and 17. The FDIC earned approximately a 6% yield on its Treasury securities in 1997 (1998 data is not yet available), as calculated from Federal Deposit Insurance Corporation (1997), pp. 47, 48, 63, and 64. Assuming a minimum reserve ratio of 1.25%:  $.0125 \times .06 \times .747 = 5.6$  basis points.

26. The shortcomings of government banking regulation are the real moral hazard in federal deposit insurance (Ely, 1997c).

27. 12 U.S.C. Sec. 343, second paragraph. Unlike banks, which can borrow at the discount window of a Federal Reserve bank without prior approval by the Board of Governors of the Federal Reserve System, loans to non-bank firms require an affirmative vote of five members of the Board of Governors.

28. 12 U.S.C. 347b(b)(1), as amended by Sec. 142 of FDICIA, provides that "[e]xcept as provided in paragraph (2), no advances to any undercapitalized depository institution by any Federal Reserve bank under this section may be outstanding for more than 60 days in any 120-day period."

29. See for example, Petri and Ely (1995). Other articles and papers on the cross-guarantee concept are posted on the Ely & Company website at <http://www.ely-co.com>.

30. On July 23, 1998, the BestBank of Boulder, Colorado, failed with total assets of \$314 million. The FDIC's estimated loss in BestBank, as of the end of 1998, was \$171.6 million, or 55% of assets; that loss percentage may go higher. As spelled out in a 74-page report issued by the FDIC's Inspector General (Federal Deposit Insurance Corporation, 1999), BestBank represents an extremely serious regulatory failure by the FDIC.

31. An amendment to H.R. 10, as reported by the House Banking Committee on March 11, 1999, would require that this capital deduction include all retained earnings in the op-sub.