The Failure of Superior Bank, FSB

Oral Statement by Bert Ely to the

Senate Committee on Banking, Housing, and Urban Affairs

September 11, 2001

Mr. Chairman and members of the Committee, thank you for inviting me to testify today regarding the Superior Bank failure. I will summarize my written testimony, which I request be included in the record of this hearing.

Superior was created in 1988 as the successor to the failed Lyons Federal Bank. In 1992, Superior acquired Alliance Funding, a wholesale originator of subprime mortgages. With Alliance, Superior became a one-trick pony that was doomed to fail.

Superior's business plan? Concentrate on subprime lending, principally on home mortgages. While Superior originated some loans with its banking customers, Alliance vacuumed up low quality loans across the country originated by independent brokers. Superior may have became a dumping ground for low-quality, and possibly predacious, mortgages. More specifically, this was Superior's modus operandi:

- Vacuum up subprime mortgages;
- Use insured deposits to warehouse these mortgages on the Superior balance sheet;
- Service the mortgages;
- Periodically securitize the warehoused mortgages;
- Sell the mortgages, for securitization purposes, for more than they really are worth by taking back interest-only strip receivables and other securitization residuals that can be treated as an asset. In effect, retained interests in the securitized mortgages represented a hidden price discount on the mortgages sold; and
- By selling mortgages for more than they really are worth, report artificially high profits, in the form of gain-on-sale income, which enables substantial dividend payouts as well as the appearance of high capital levels.

Superior's Thrift Financial Reports, or TFRs, support this theory:

- Superior first reported gain-on-sale income in 1993, after acquiring Alliance Funding.
- From 1994 to 1999, Superior's gain-on-sale income exceeded its pre-tax income by more than $72 million. In effect, Superior consistently lost money before recording its gain-on-sale income.

- Starting in 1993, Superior accumulated substantial retained interests in mortgage securitizations.

- Superior paid $188 million in dividends in the 1992-99 period, giving Superior's stockholders an 18.1 percent return on their initial investment.

- Despite substantial dividend payments, Superior accumulated capital through the retention of reported earnings. However, this capital was a mirage. In late 2000, Superior's reported capital shrank $260 million, to $38 million, or 1.8 percent of its assets, largely due to asset writedowns. This made Superior "critically undercapitalized" under Prompt Corrective Action.

Superior's regulators, and specifically the OTS, failed miserably in supervising Superior:

- The OTS failed to recognize the fundamentally flawed business model Superior adopted when it acquired Alliance.

- Key to Superior's flawed model was retaining the worst portion of its asset securitizations. Had the OTS been more aggressive in properly valuing Superior's securitization-related assets, Superior could not have continued in business.

- The OTS apparently failed to appreciate the extent to which Superior was an outlier among thrifts -- it was far from typical.

- Superior did not reserve adequately for future loan charge-offs and asset writedowns, causing its capital to be overstated.

- Superior relied heavily on non-retail deposits, including brokered deposits, to fund the growth of its securitization-related assets.

- Especially troubling was Superior's gathering of uninsured deposits, which peaked at $572 million in March of 2000. After dropping for a year, they rose $9.6 million from March 31 to June 30 of this year. Had the OTS moved more quickly to close Superior, new uninsured depositors would not have suffered any loss. Now they will suffer a significant loss.
- A major problem in assessing Superior's true condition were the often erroneous TFRs it filed with the OTS. One cannot assess an institution's financial condition based on faulty data.
- Despite TFR inaccuracies and overvalued assets, Superior clearly was deeply insolvent. Based on September 30, 2000, TFR data, I wrote to OTS Director Ellen Seidman on February 9th of this year warning her about Superior's looming insolvency. A copy of that letter is attached to my testimony.

- The FDIC is not blameless, either. Although it raised concerns about Superior in late 1998, did the FDIC pound the table hard enough about Superior's declining condition? I doubt it. Also, the FDIC appears not to have developed a "Plan B" to

execute if the Pritzker/Dworman recapitalization plan for Superior fell through. This unpreparedness is evidenced by the FDIC placing Superior in a conservatorship, adding to its insolvency loss.

Let me now turn to broader regulatory issues. There have been 35 FDIC-insured bank and thrift failures since the beginning of 1995. Three of them -- Superior, Keystone, and BestBank -- account for $1.76 billion, or 87 percent, of the FDIC's $2 billion of losses since 1995

The loss amount in these three failures is so high because the insolvency loss percentage in these failures is high, ranging up to 75 percent in the Keystone caper. Despite the regulators' best efforts, though, there will be the occasional failure of small institutions, the "fender-benders" of deposit insurance. Of the 35 failures since 1995, 24 were fender-benders. They do not represent a major public policy concern.

A high loss percentage strongly suggests that the regulators moved far too slowly in resolving a weak institution. Rather than trying to save a bank to keep it independent, regulators should force weak institutions to merge into stronger institutions or to liquidate prior to insolvency.

One troubling thread running through some of the most expensive failures was a bank management team that vigorously fought efforts by examiners trying to assess the bank's financial condition. Instead of being cowed, examiners who face a resistant management should dig even harder to uncover the problems management obviously is hiding.

What is especially troubling in the costly failures has been the buckpassing and finger pointing by the regulators, specifically in asserting that outside auditors have the responsibility to detect fraud and properly value a bank's assets. In fact, a key responsibility of banking regulators is to detect fraud and properly value assets. I estimate that Superior paid the OTS $760,000 in 2000 in examination fees as well as substantial fees in earlier years, enough to permit the OTS to hire outside experts to estimate the value of Superior's securitization-related assets.

Most disturbing of all is the sense that the federal bank regulators do not understand their fiduciary obligation to the banking industry to minimize insolvency losses. Regulators owe this fiduciary obligation because it is the banking industry and not taxpayers, who stand first in line to pay for regulatory failure. If the regulators do a good job of protecting bankers' pocketbooks, the taxpayer will automatically be protected.

This lack of a sense of fiduciary obligation raises this question -- are regulators too concerned about examination fees? One can reasonably wonder if the prospective loss of $760,000 in exam fees deterred OTS from moving more quickly to close Superior.

One additional point merits a mention -- the concept of depositor discipline, which provides the rationale for a deposit insurance limit. Yet how could large depositors determine the true state of Superior's financial condition based on its TFRs?

Many believe deposit insurance creates a moral hazard -- that insured depositors are indifferent to a bank's financial condition. But regulatory moral hazard trumps depositor moral hazard if regulators publish erroneous information on which to judge an institution's condition or if regulators delay closing an insolvent one. Regulatory moral hazard is the real issue Congress should address. Attached to my written testimony is an article addressing this issue, "Regulatory Moral Hazard: The Real Moral Hazard in Federal Deposit Insurance."

I will close by offering some legislative recommendations:

- Require more accurate, frequent, and conservative valuations of risky assets.

- Require the bank regulatory agencies to develop their own capabilities to detect fraud and to value all types of bank assets.

- Do not raise capital standards for intervention under Prompt Corrective Action as that will not prevent bank failures with high loss percentages.

- Direct the FDIC to levy losses above a certain percentage of a failed institution's assets on its federal or state chartering agency.

- Provide for tough sanctions and even job termination for high level personnel in the agencies responsible for supervising a failed institution with a high loss percentage.

- Strengthen the FDIC's intervention powers, particularly when off-site monitoring suggests a lower CAMELS rating than the chartering agency has established.

- Give the FDIC greater power to force the closure of state-chartered institutions.

- Recognize that sufficiently high risk-sensitive premiums would provide weak banks with a powerful financial incentive to recapitalize or sell before insolvency is reached.
- Do not permit the FDIC to rely upon reinsurance premium rates to establish risk-sensitive premium rates for large banks. A reinsurer must not only take into account a bank's insolvency risk, but the greater risk that the chartering agency will move too slowly to close a failing bank.

- Require public notification of amended TFRs and bank call reports to alert depositors and outside analysts to a possible decline in a bank's financial condition.

- These recommended reforms may not overcome regulatory moral hazard, which should trigger more fundamental reforms. At that point, I would urge Congress to consider the cross-guarantee concept to delegate to the private sector the full responsibility for ensuring the safe-and-sound operation of banks. This concept is summarized in my "Regulatory Moral Hazard" article.

The Superior Bank failure is quite troubling, coming on the heels of the unnecessarily expensive Keystone and BestBank failures. Congress needs to probe deeply into regulatory failings underlying these failures and to respond to their causes and not their symptoms.

Mr. Chairman, thank you. I welcome the Committee's questions.

The Failure of Superior Bank, FSB

Testimony by

Bert Ely

to the

Senate Committee on

Banking, Housing, and Urban Affairs

September 11, 2001

Ely & Company, Inc.
P.O. Box 21010
Alexandria, Virginia 22320
Voice: 703-836-4101
Fax: 703-836-1403
Email: bert@ely-co.com
Website: www.ely-co.com

The Failure of Superior Bank, FSB

Testimony by Bert Ely

Mr. Chairman and members of the Committee, I want to thank you for the opportunity to testify today regarding the July 27, 2001, failure of the Superior Bank, FSB, which was headquartered in Oakbrook Terrace, Illinois. My testimony will address several issues regarding the Superior failure: My theory as to why Superior failed, a review of the regulatory shortcomings that led to this very expensive failure, broader regulatory problems that have been quite evident in some very expensive bank and thrift failures in recent years, and legislative recommendations to at least lessen these problems, if not eliminate them.

Why Superior Failed

Superior, under the Pritzker/Dworman ownership, was created at the end of 1988 as the successor to the failed Lyons Federal Bank, FSB, one of the infamous S&L resolutions that year. Like many other 1988 S&L resolutions, Superior started life with enormous tax benefits and a substantial amount of FSLIC-guaranteed assets. However, Superior could not profit indefinitely from its FSLIC launch -- it had to develop a long-term business strategy. Enter Alliance Funding, Superior's wholesale mortgage origination division, which Superior acquired at the end of 1992. With Alliance on board, Superior became a one-trick pony that was doomed to stumble, fatally, one day, or in this case eight and one-half years later.

Superior's trick, or business plan, was to concentrate on subprime lending, principally on home mortgages, but for a while in auto lending, too. While Superior originated loans as a retail lender in the Chicago area, that is, making loans directly to consumers through its own offices, my sense is that it originated or purchased most of its loans through Alliance, which is headquartered in Orangeburg, New York, outside of New York City in Rockland County. Working from its home office and ten branches around the country, Alliance either purchased loans originated and funded by independent mortgage bankers or it funded in its own name mortgages originated by mortgage bankers and brokers. In effect, Alliance vacuumed up subprime loans, that is of B, C, and D credit quality, across the country for later securitization. It appears that Superior became a dumping ground for low-quality, and possibly predacious, mortgages that brokers could not sell elsewhere. There also are reports that Superior loosened its loan underwriting standards in 1999 to attract additional mortgage business.

I encourage Committee members and their staff to visit the Alliance website, www.allfun.com, to get a full flavor of the types of mortgages Alliance specialized in, including "limited and no credit borrowers," "mortgage down 3 months or foreclosures," "80% LTV for recent discharge from Bankruptcy," "borrowers can't source down payment," "fixed income is grossed up 135%," "full array of options for stated income and limited documentation borrowers," "highest LTVs in the industry for rural properties," "open Chapter 13 Bankruptcies at 75% LTV," "second homes are considered owner-occupied," "second

mortgage behind private allowed," and so forth. In addition to mortgages, Superior also engaged in auto lending, most heavily in 1998 and 1999, with a substantial phase-down of that business in 2000. I do not wish to condemn subprime lending in general, but clearly Superior engaged in high-risk lending that ultimately was its downfall.

Briefly, Superior appears to have adopted this business model:

- Vacuum up subprime mortgages, and originate a few, too:
- Warehouse the mortgages on the Superior balance sheet, using insured deposits to fund that warehouse;
- Service the mortgages;
- Periodically securitize some of the mortgages, usually on a quarterly basis, while retaining the servicing rights to them;
- Sell the mortgages, for securitization purposes, for more than they really are worth, but hide that fact by taking back interest-only strip receivables and other securitization residuals that can be treated on Superior's balance sheet as an asset. In effect, the retained interests in the securitized mortgages represented a hidden price discount to facilitate their sale;
- By selling mortgages for more than they really are worth, report excessive profits or gains on the sale of those mortgages for securitization purposes; and
- Report artificially high net income, because of excessive gain-on-sale income, which enables substantial dividend payouts as well as the appearance of high capital levels.

Evidence from Superior's Thrift Financial Reports (TFR), which Superior filed quarterly with the Office of Thrift Supervision (OTS), supports this theory:

- Superior first reported gain-on-sale income in 1993, the first full year after Superior's December 31, 1992, acquisition of Alliance Funding.
- From 1994 to 1999, Superior's gain-on-sale income increased each year. For the five years from 1995 to 1999, Superior's gain-on-sale income totaled $487 million, $72 million more than Superior's pre-tax income. In effect, Superior consistently lost money before taking into account its gain-on-sale income. For the thrift industry as a whole, less Superior, gain-on-sale income usually equals about 10 percent of pre-tax income.
- Starting in 1993, Superior began accumulating the types of assets associated with retained interests in mortgage securitizations. While the precise amount of these

assets cannot be determined from Superior's TFRs, the balance sheet categories in which these assets are placed accounted for an increasing proportion of Superior's assets[1]. Assets in these categories rose from 20 percent of Superior's total assets at the end of 1992 to 34 percent the following year-end, to 56 percent in 1996, 60 percent the following year, and to a peak of 65 percent at the end of 2000. While this percentage has been rising for the thrift industry as a whole, the industry percentage has been much lower; for example, it rose from 9 percent at the end of 1997 to 13 percent at the end of 2000.

- Superior paid $188 million in dividends in the 1989-99 period, which gave Superior's stockholders an 18.1 percent return on their initial investment of $42.5 million in Superior. These stockholders also may have reaped additional profits from the substantial tax benefits the federal government gifted to them when they acquired Lyons.

- Despite its substantial dividend payments, Superior accumulated an impressive amount of capital on its balance sheet through the retention of reported earnings. From $59.4 million at the end of 1992, equal to 6.1 percent of its assets, Superior's book capital rose to $297.6 million at the end of 1999, equal to 13.8 percent of its assets. Superior's tax benefits as successor to the defunct Lyons Savings Bank helped this capital accumulation. From 1992 to 1998, Superior reported pre-tax income of $289.7 million on which it claimed a federal tax credit of $10.6 million. Only in 1999, did Superior begin to pay a meaningful amount of federal income tax. However, Superior's capital was a mirage, for in 2000, Superior's reported equity capital shrank $260 million, to $38 million (1.8 percent of assets), largely due to "other adjustments" in its capital accounts in the fourth quarter of 2000. This reduced capital percentage made Superior "critically undercapitalized" under the Prompt Corrective Action standards for regulatory intervention established in the FDIC Improvement Act of 1991.

Regulatory Shortcomings That Led to a Very Expensive Failure

Superior's regulators, and specifically the OTS, failed miserably in their supervision of Superior. Hopefully, the forthcoming inspector general and General Accounting Office reports on the Superior failure will provide a detailed insight into and documentation of these failings. However, even now important conclusions can be drawn from the public record, specifically from Superior's TFRs. My key conclusions are as follows:

- The OTS failed to recognize the fundamentally flawed business model Superior adopted when it acquired Alliance Funding at the end of 1992. Instead, OTS

[1] The balance sheet categories are: mortgage derivative securities, other mortgage pool securities, interest-only strip receivables and other instruments, and all other assets.

appears to have permitted Superior to pursue that model for over eight years, until its closure on July 27. The preceding section of this testimony summarizes that flawed business model.

- The linchpin of Superior's flawed model was retaining the worst portion of its asset securitizations. Hence, we see the steady buildup of dubious, non-mainstream-thrift types of assets on Superior's balance sheet. Worse, it appears that these assets were consistently overvalued for many years. Had the OTS taken a greater initiative to independently establish conservative valuations of Superior's securitization-related assets, Superior would have been forced to adopt a more profitable business model or sell itself to a stronger financial institution. The First National Bank of Keystone failure on September 1, 1999, should have immediately set the OTS alarm bells ringing about Superior since it owned a far larger amount of residual interests than did Keystone.

- The OTS apparently failed to appreciate the extent to which Superior was an outlier among thrifts -- it was far from being the typical post-FIRREA thrift. For example, at the end of 1997, almost four years before Superior failed, it had almost seven times as much invested in the asset categories containing securitization-related assets, per dollar of total assets, as did the rest of the thrift industry. For 1997, Superior's gain-on-sale income, per dollar of pre-tax income, was twelve times the industry average that year. Most startling, at the end of 1997, Superior's recourse exposure related to assets sold, per dollar of capital, was 31 times the industry average. Even a rudimentary comparative analysis of Superior's TFR data with thrift industry data should have flagged it as an outlier worthy of special attention years before it failed.

- It is not at all clear if Superior was reserving adequately for future loan charge-offs and asset writedowns on a timely basis, particularly towards the end. Any underreserving for future charge-offs and writedowns, of course, would be another factor causing Superior's capital to be overstated.

- In a throw-back to the S&L crisis, Superior appears to have relied to a great extent on non-retail deposits to fund the growth of its securitization-related assets. My rough estimate is that less than half of Superior's deposits were genuine retail deposits held by individuals and businesses located within a reasonable proximity of Superior's 17 branches. At June 30, 2000 (the last date for which branch deposit data is available), Superior's La Grange Branch reported $827 million in deposits while its Berwyn and Downers Grove branches reported deposits of $143 million and $123 million, respectively.[2] They are hardly your typical retail branch. Also, Superior started attracting brokered deposits in 1998 but brokered deposits

[2] FDIC's annual Summary of Deposit data by bank and thrift branch can be found at www.fdic.gov.

declined significantly during 2000 from $403 million at the end of 1999; they had dropped to $81 million by June 30 of this year.

- Especially troubling was Superior's gathering of uninsured deposits. Superior significantly increased its uninsured deposits in 1998, the year it began taking brokered deposits as it grew its assets from $1.3 billion to $1.8 billion. Uninsured deposits jumped in 1998 from $93 million to $316 million and then rose to $569 million at the end of 1999 before hitting a quarterly peak of $572 million on March 31, 2000. After dropping $80 million over the next six months, uninsured deposits went into a free-fall, plunging $440 million, or 89 percent, from last September 30 to March 31 of this year. This drop may reflect a correction of past accounting errors, apparently a frequent problem at Superior, or a genuine run by larger depositors. I trust the inspector generals and the GAO will investigate what sparked that drop. I am even more troubled by the almost obscene increase in Superior's uninsured deposits during the second quarter of this year, when they rose $9.6 million. Had the OTS moved more quickly to close Superior, those new uninsured depositors would not have suffered any loss. As it is, they will suffer a significant loss.

- A major problem any outsider experienced in trying to assess Superior's true condition were the often erroneous TFRs Superior filed with the OTS. In reviewing Superior's TFR data, as made available on CDs sold by Sheshunoff & Company, I have found numerous inconsistencies and unreconciled differences in Superior's financial data that stem from the quiet filing of amended TFRs. For example, until the March 31, 2000, TFR Superior had reported no interest-only strip receivables. Suddenly, on that date, Superior report $644 million of interest-only strips, which accounted for 28 percent of its total assets. Previously, those interest-only strips appear to have been classified on Superior's TFRs as "mortgage derivative securities."

  A far more egregious reporting incident occurred for the fourth quarter of 2000. Superior's initial TFR for December 31, 2000, reported that it had $255.7 million in capital on the date, for an 11.2 percent leverage capital ratio, which is quite strong. However, sometime this spring, Superior filed an amended TFR showing just $37.9 million of capital, for a capital ratio of just 1.8 percent, which means that Superior was critically undercapitalized at the end of last year. This data may not have been published on the FDIC website until as late as June. Quite possibly, uninsured depositors in Superior were misled by that initial TFR. Over the years, OTS failed badly in ensuring that Superior filed accurate TFRs the first time.

- Despite TFR inaccuracies and overvalued assets, it was possible to determine that Superior was deeply insolvent as early as last September 30. Based on Superior's TFR data as of that date, I sent a letter to OTS Director Ellen Seidman warning her about Superior's looming insolvency; a copy of that letter is attached to this testimony. OTS never replied to my letter. The rest is history. What is

particularly troubling about that history is Superior's rapid deterioration after September 30 and even more so after the first of this year. Superior's capital ratio declined sharply, from 13.5 percent on September 30 to 3.1 percent six months later. Of course, Superior's reported negative capital of $197 million on June 30 of this year strongly suggests that Superior's capital was grossly overstated on March 31, and much earlier.

Other measures suggest declining asset quality. For example, unpaid interest on mortgages Superior owned rose from 1.1 percent last September 30 to 4.7 percent on March 31 of this year; the thrift industry average on March 31 was .58 percent. This disparity suggests that Superior was experiencing a substantial increase in delinquencies in its mortgage portfolio. A similar deterioration was observed for loans Superior was servicing for others, which largely consisted of loans it had securitized. Advances by Superior on these loans to pay principal, interest, taxes, and insurance rose steadily, from 1.5 percent at the end of 1999 to 1.9 percent on September 30, 2000, to 2.1 percent at the end of 2000, to 3.0 percent on March 31, 2001, and to 3.2 percent on June 30 of this year. This rising percentage strongly indicates a deterioration in the loans Superior has securitized, which suggests a further impairment in the value of Superior's securitization-related assets.

! The FDIC is not fault-free in this situation. Although the FDIC reportedly raised concerns about Superior in December 1998, when it sought to examine Superior, and was denied by the OTS, one must still wonder if the FDIC pounded the table hard enough in closed-door meetings of the FDIC Board (on which Ms. Seidman sits) about Superior's declining condition. Given the depth of Superior's insolvency, one can reasonably wonder if the FDIC did enough to push for an earlier closure of Superior, particularly since (1) the FDIC "didn't like the [Superior] recapitalization plan[3]" and (2) FDIC personal were at Superior continually, starting 96 days before Superior was closed.[4] Also, given the FDIC's long-standing concerns about Superior and its eventual access to the institution, the FDIC seems not to have been prepared for OTS's decision to close Superior. In effect, the FDIC appears to have not developed a "Plan B" to execute immediately if the OTS's "Plan A," the Pritzker/Dworman recapitalization of Superior proposed on May 24, 2001, fell through.

This unpreparedness is evidenced by the FDIC's decision to continue operating Superior in a conservatorship rather than to immediate sell its branches, its retail deposit franchise, and what few good assets Superior has. However, it is highly unlikely that a single buyer will purchase all of Superior's good assets. Most

[3] American Banker, August 9, 2001.

[4] American Banker, August 21, 2001.

likely, a Chicago-area depository institution will purchase the Superior branches while a subprime mortgage specialist will purchase Alliance Funding and Superior Servicing, Superior's servicing arm. Although it can never be calculated, the FDIC probably has increased the eventual Superior insolvency loss through its bungling of the Superior closure.

The OTS summed up quite well Superior's numerous shortcomings in a news release it issued on July 27, 2001, the day it closed Superior:

> "Superior Bank suffered as a result of its former high-risk business strategy, which was focused on the generation of significant volumes of subprime mortgage and automobile loans for securitization and sale in the secondary market. OTS found that the bank also suffered from poor lending practices, improper record keeping and accounting, and ineffective board and management supervision. Superior became critically undercapitalized largely due to incorrect accounting treatment and aggressive assumptions for valuing residual assets."

Ms. Seidman, in testimony delivered to the Financial Institutions and Consumer Credit Subcommittee of the House Financial Services Committee just 31 hours before she closed Superior suggested that "certain types of non-traditional smaller institutions" could fail suddenly. Although she may have had Superior in mind that day, that statement certainly is not applicable to Superior. Superior did not fail suddenly nor was its failure a surprise, for it planted the seeds of its self-destruction eight and one-half years earlier. The fundamental question which must be asked, and answered: Why did the OTS tolerate that self-destructive business strategy?

Broader Bank Regulatory Problems That Have Become Quite Noticeable in Recent Years

From the beginning of 1995 to last Friday, there have been 35 bank and thrift failures, 33 of which caused a loss to the BIF and/or the SAIF. Attached to this testimony is a table listing these 35 failures. Losses range in size from an estimated $80,000 to $780 million, the latest loss estimate for the Keystone fiasco. Although the FDIC has not yet announced a loss estimate for the Superior failure, I plugged a $750 million figure in the table, which reflects my gross loss estimate of approximately $1 billion less that portion of the loss that will be borne by uninsured depositors and general creditors as well as litigation recoveries, net of litigation expenses. As the table shows, three failures -- Superior, Keystone, and BestBank -- account for $1.76 billion, or 86 percent, of the estimated BIF/SAIF losses over the last six and two-thirds years.

The loss amount in these three failures, which also happen to be the three largest institutions to fail, is so high largely because the insolvency loss percentage in these failures

is so high, ranging up to 75 percent in the Keystone caper. A fourth failed bank, Pacific Thrift and Loan Company, with the fourth-highest loss amount, experienced the second-highest loss percentage of 68 percent. BestBank was third at 61 percent and Superior appears to come in fourth, at 43 percent, although that percentage will change as the FDIC gets a better fix on Superior's ultimate loss amount. Had the loss percentage in each of these four failures been held to 30 percent -- still a high percentage, especially for larger institutions -- the insolvency loss in these four cases would have been trimmed by over $800 million, or 40 percent of the FDIC's insurance losses since 1995.

Four charts appended to this testimony graphically place these expensive failures in perspective with other bank and thrift failures. **Figure 1** contrasts the handful of extremely expensive failures since 1995 with the multitude of relatively inexpensive failures. **Figure 2** presents this contrast in another manner, as a stacked bar. **Figure 3** shows a distribution of FDIC insolvency losses as a percentage of assets in the failed institutions. Two of the six institutions listed by name (Commonwealth Thrift and Loan and Union Federal, FSB, were small institutions. **Figure 4** ranks the ten most expensive FDIC-insured failures since 1986 based on their insolvency loss as a percentage of total assets. Although Superior and Keystone were the smallest two of these ten institutions, in terms of assets at the time of failure, they made the "top ten" list because of their high loss percentages.

It is clear from the table and the charts that there have been numerous instances, even among small institutions where high loss percentages can reasonably be expected, where the loss percentage has been fairly low -- under 10 percent or 20 percent. It is not unreasonable to classify low-cost failures of smaller banks and thrifts as the occasional "fender-benders" of the deposit insurance business. Of the 35 FDIC-insured failures since the beginning of 1995, I have characterized 24 of them as fender-benders.[5]

Failures with high loss percentages, including the four I just cited, strongly suggest that at least some of the time the regulators have moved far too slowly in getting a bank or thrift turned around, recapitalized, sold, or closed. This is a troubling situation that could worsen as the economy continues to slow down or if it slides into a recession. Therefore, the four federal bank regulatory agencies should get much more aggressive and move much more quickly to resolve problem situations before they create an insolvency loss. Given the insolvency risk of trying to save a weak bank or thrift so that it can remain independent, regulators should become much more aggressive in forcing weak institutions to merge into stronger institutions or to liquidate prior to insolvency, as Pacific Southwest Bank, FSB, did earlier this year.

One troubling thread running through some of the most expensive failures was a bank management team that vigorously fought efforts by examiners trying to gain a good understanding of the bank's financial condition and operating practices. That clearly was the

---

[5] A deposit insurance fender-bender is rather arbitrarily and liberally defined as (1) a failed institution with less than $50 million in assets and an insolvency loss percentage below 30 percent, (2) an institution with assets between $50 million and $100 million and a loss percentage below 20 percent, or (3) an institution with more than $100 million of assets and an insolvency loss below $5 million.

case in the BestBank and Keystone failures. Apparently that happened to some extent at Superior. According to an article in last Friday's American Banker, Ms. Seidman stated at a news conference the previous day that OTS examiners "were confronted with a management that was `fighting back hard' against the [OTS's] criticisms." It amazes me that examiners were cowed in these situations given that that type of resistance often signals severe problems in the institution. Instead of being cowed, examiners who face a management "fighting back hard" should dig even harder and deeper to uncover the problems the management obviously is hiding.

What is especially troubling in the most costly failures has been the amount of buckpassing and finger pointing by the regulators, specifically in asserting that it is up to a bank's or thrift's outside auditors to detect fraud and properly value assets. In the Superior case, the OTS has been especially vociferous in asserting that Ernst & Young, Superior's auditors, was slow to properly value the securitization residuals on Superior's balance sheet.[6] In fact, fraud detection and asset valuation are absolutely central to the effective examination and supervision of depository institutions. Given the importance of these activities, bank regulators must make reasonable efforts to detect fraud and to properly value assets, with their own staffs or outside contractors, rather than relying on independent parties, such as an institution's accounting firm. I estimate that Superior paid the OTS $760,000 in 2000 in examination fees as well as substantial fees in earlier years. Those sums certainly were sufficient to permit the OTS to obtain the assistance of outside experts in periodically estimating the value of Superior's securitization-related assets. Any plea by the OTS that it was hamstrung by Ernst & Young in valuing Superior's residual interests is patently absurd.

Most disturbing is the sense that the federal bank regulators neither embrace or even understand their fiduciary obligation to the banking industry to minimize insolvency losses without being unduly restrictive of banking activities. Regulators owe this fiduciary obligation because it is the banking industry, through past and future deposit insurance assessments, and not taxpayers, who stand first in line to pay for regulatory failure. Good banks and thrifts don't let bad institutions fail, regulators do. If the regulators do a good job of protecting bankers' pocketbooks, the taxpayer will automatically be protected.

This absence of a sense of fiduciary obligation raises this question -- why are regulators not concerned about the impact of their failures on deposit insurance assessments? Partly it may be regulatory tradition and a lack of personal accountability on the part of senior regulatory management. After all, how many senior regulators have been fired over the last 20 years because of the almost 2,800 bank and thrift failures that have occurred? But there may be another reason, particularly at the OTS, for this lack of fiduciary obligation, and that is survival of the OTS, which is dependent upon its ability to generate examination fees. According to OTS financial statements posted on the OTS website (www.ots.treas.gov), the OTS slid from an $18 million profit in 1996 to a

[6] From 1964 to 1966, I was on the audit staff of Ernst & Ernst, a predecessor firm to Ernst & Young. I have no ties to Ernst & Young at this time.

$13 million loss in 2000. According to an August 28, 2001, American Banker article, the OTS projects that it will return to profitability in 2003. Perhaps its will, but maybe it will not as the number of thrifts continues to decline. One can reasonably wonder if the prospective loss of $760,000 annually in exam fees deterred senior OTS management from moving more quickly to close Superior.

One additional point merits a mention in this discussion of broader regulatory problems that Congress should ponder, and that is the concept of depositor discipline. The notion of depositor discipline is the rationale for a deposit insurance limit, on the theory that large, uninsured depositors, armed with accurate, timely information about a bank's condition, will run from a weak institution, thereby ringing an alarm bell to wake up sleepy regulators. As I noted above, there appears to have been a substantial run by uninsured depositors from Superior last winter. What triggered this apparent run is a mystery, as is its effect on the OTS. Assuming a 40 percent loss rate, those uninsured depositors who fled Superior from last October to March of this year escaped a $175 million loss. As it is, the 816 depositors holding $66.4 million of uninsured deposits when Superior was closed[7] (an average of $81,400 per depositor) face a loss in the $25 million range. How could large depositors, such a former parcel deliverywoman who deposited a $145,000 disability payment in Superior the day before it closed[8], determine the true state of Superior's financial condition based on then publicly available call reports?

Many believe that deposit insurance creates a moral hazard, in that insured depositors care not a whit about a bank's or thrift's financial condition. But regulatory moral hazard trumps depositor moral hazard if regulators publish erroneous information on which to judge an institution's condition, as OTS did in the Superior situation, or if regulators inexplicably drag their feet in closing an insolvent institution, as the OTS did in the Superior situation. Although seldom discussed, regulatory moral hazard is the real issue Congress must now address, not depositor moral hazard. Attached is an article of mine, "Regulatory Moral Hazard: The Real Moral Hazard in Federal Deposit Insurance," which provides insights into this problem.

Legislative Recommendations

Superior's failure teaches many lessons, and will teach more as its causes become better understood. However, from both a legislative as well as a regulatory perspective, it is important to not to draw the wrong conclusions from these lessons and according enact new laws and adopt new regulations that will worsen matters. The following are my legislative recommendations stemming from the Superior failure:

---

[7] American Banker, August 14, 2001.

[8] Ibid.

- Require more accurate and more frequent valuations of risky assets that err on the conservative side. This approach would be much better than higher capital requirements on risky types of assets. While it is much easier to set higher uniform capital standards, those standards will (1) drive less risky assets off bank balance sheets (this is called "regulatory arbitrage") and (2) postpone the day when asset values, and therefore capital levels, are realistically recognized on an institution's balance sheet. Also consider barring a financial institution from retaining any portion of its asset securitizations so that a true market value is established for the assets when they are sold.

- Do not raise capital standards for intervention under Prompt Corrective Action as that will not make a meaningful difference in preventing bank and thrift failures with high loss percentages. However, higher intervention standards could cause sound, well-run banks and thrifts to overcapitalize themselves, which would drive lower-risk assets off of bank balance sheets (another form of regulatory arbitrage).

- Empower the FDIC to levy losses above a certain percentage of a failed institution's assets -- say above 20 percent or 30 percent -- on the chartering agency of the bank. The agency would then have to pass that levy back to the institutions it has chartered through higher exam fees. The institutions chartered by that agency would then have a powerful incentive to pressure the agency's top management to prevent future high-loss-percentage failures.

- Provide for tough personal sanctions and even job terminations for high level personnel in the agency or agencies responsible for the supervision of a failed institution with a high loss percentage. While a failed institution's management is directly responsible for its failure, the institution's regulators must be held personally accountable if the subsequent insolvency loss is too high.

- Require the bank regulatory agencies to develop the capabilities -- either internally or under contract -- to detect fraud and to value all types of bank and thrift assets. While regulators should review reports from a bank's or thrift's outside auditors to gain an additional perspective on the institution, regulators should not place any reliance on audit reports for either examination or supervisory purposes.

- Strengthen the FDIC's intervention powers, particularly when off-site monitoring suggests a lower CAMELS rating than the chartering agency has established. At a minimum, FDIC personnel should be able to accompanying another agency's examiners on an already-scheduled examination without the consent of the other agency. However, because examinations are disruptive to banks and thrifts, the FDIC should not be given the authority to conduct back-up exams on its own initiative. If a chartering agency refuses to let the FDIC do a back-up examination, the agency should be required to give the FDIC a confidential memorandum explaining the reasoning behind its denial. If the institution later fails with a high loss percentage, then that memorandum should be

taken into consideration in determining how best to discipline senior management of the chartering agency (see above).

- Give the FDIC greater power to force the closure of state-chartered institutions. Under no circumstances should a state banking department have the final authority over the closure of bank or thrift whose insolvency would cost the participants in a federally administered deposit insurance program. If a state government wishes to retain the ultimate closure decision, then it should reimburse the FDIC for any insolvency loss the FDIC might otherwise incur.

- Acknowledge that sufficiently high risk-sensitive premiums, levied on the basis of leading indicators of banking risk, would provide weak banks with a powerful financial incentive to recapitalize or sell before insolvency is reached. An injection of capital should lead to a sufficient lowering of premiums to pay for that additional capital. That incentive might be more successful in avoiding insolvency losses than relying upon banking supervisors to turn around 4- and 5-rated banks.

- Do not permit the FDIC to rely upon reinsurance premium rates to establish risk-sensitive premium rates for large banks as those rates will be too high given that a reinsurer must not only take into account the risk that a bank will become insolvent, but the possibly greater risk that the chartering agency will be slow to close a failing bank. Superior amply demonstrates the closure risk any reinsurer faces.

- There should be public notification of the filing of amended TFRs and bank call reports to alert depositors and outside analysts of a possible decline in a bank's or thrift's financial condition. If depositor discipline is ever to be meaningful, particularly for banks and thrifts which do not file financial statements with the Securities and Exchange Commission, then it is absolutely vital that depositors have access to timely, accurate information with which to assess a bank's or thrift's financial condition and probability of failure.

- These recommended reforms ultimately may not be sufficient to overcome regulatory moral hazard, in which case Congress should pursue more fundamental reforms. Former Treasury General Counsel Peter J. Wallison proposed in an attached April 27, 2001, op-ed in the American Banker, headlined "Industry, Not Government Is the Real Deposit Insurer," that the banking industry "establish the loss reduction policies that the FDIC enforces -- especially those concerning bank examinations and insurance premiums." I go one step further in advocating the cross-guarantee concept to delegate to the private sector the full responsibility for ensuring the safe-and-sound operation of banks and thrifts. This concept is summarized on pages 251 and 252 in my "Regulatory Moral Hazard" article cited above.

Conclusion

The Superior Bank failure is quite troubling, coming on the heels of the unnecessarily expensive Keystone and BestBank failures. I urge Congress to probe deeply into the regulatory failings leading up to these failures and to respond to their causes and not their symptoms.

Mr. Chairman, I thank you again for the opportunity to testify today in this most important matter. I welcome your questions and questions from your colleagues.

February 9, 2001

The Honorable Ellen S. Seidman
Director
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552

Re: Superior Bank, FSB; Oakbrook Terrace, Illinois

Dear Ellen:

I am writing to express my very deep concern about the solvency of Superior Bank, FSB, of Oakbrook Terrace, Illinois (OTS Docket Number 8566). While Superior appears to be quite well capitalized (tangible equity capital ratio of 13.5%), its substantial and growing proportion of assets with highly questionable values, reminiscent of the First National Bank of Keystone, strongly indicates that Superior in fact is deeply insolvent. Further, I question whether the Pritzker family will ride to Superior's rescue. Also, as the enclosed article from the February 5, 2001, issue of Chicago Business reports, Fitch has placed Superior on a long-term negative credit watch.

Enclosed are selected pages from the Sheshunoff call report data on Superior. I comment below on my principal concerns about Superior; other problems at this thrift also are quite evident, based on call report data and other information.

- Superior has three categories of assets ("Mortgage Derivative Securities," "Interest-Only Strip Receivables & Other Instruments," and "Advances for Loans Serviced by Others," as shown on pages 1 and 2 of the call report data) that constitute an increasing portion of Superior's balance sheet. Taken together, these three categories of assets rose from 36.7% of Superior's total assets at the end of 1997 to 43.7% at the end of 1999 and to 59.6% on September 30, 2000 (page 3). The book values for these assets are highly questionable. If the I-O Strips alone are worth only half of their book value, Superior would be insolvent on a book-value basis. Keystone, of course, taught that I-O strips arising from the securitization of low-quality loans are, at best, worth pennies on the dollar.

- Superior clearly has serious asset quality problems, with an extremely high level of loss provisioning. "Total Net Charge-Offs" for the first nine months of 2000 of $200.2 million (page 9) equaled 8.8% of Superior's assets at the beginning of 2000. Especially troubling was a $78.5 million reduction in "General Valuation Allowances" in the third quarter of 2000 that was not included in Total Net Charge-Offs, which left Superior with "Total Valuation Allowances" of just $12.2 million on September 30, 2000 (page 6). That amount is far too low given Superior's high risk lending, asset quality problems, and substantial "Balance of Assets Sold with Recourse Obligations" of $3.73 billion on September 30, 2000 (page 11). Properly establishing Superior's General Valuation Allowances would wipe out much, if not all, of Superior's Equity Capital.

- A troubling parallel with Keystone was Superior's reclassification of a substantial portion ($644 million, or 30% of Superior's total balance sheet) of Mortgage Derivatives as Interest-Only Strip Receivables as of March 31, 2000 (page 2). One can only wonder what other errors there are in Superior's call reports in light of this reclassification as well as the apparent underreporting of asset charge-offs discussed under the previous bullet.

- Although its reliance on "Broker Originated Deposits" has declined somewhat (page 13), Superior still relies too much on brokered deposits ($286 million at September 30, 2000). Also, Superior had far too much in uninsured deposits ($492 million at September 30, 2000) for an insolvent institution about to get a Fitch downgrade (page 13). That downgrade could trigger liquidity and funding problems at Superior.

- Superior's "Net Interest Income Before Provision for Losses" dropped dramatically during the first three quarters of 2000 (page 4). On an annualized basis, this income line was down 78% from 1999, which is quite serious given Superior's high level of losses on loans and other assets.

- Superior's "Other Noninterest Income" for the first nine months of 2000 was running at five times 1999's rate for that income item, which is highly suspicious given Superior's overall profitability problems.

- Superior's "Marketing and Other Professional Services" expense for the first three quarters of 2000 was running at double the pace of 1999, which in turn was up dramatically from earlier years. Perhaps this is why I am seeing so many Superior ads on CNBC.

I have identified other problems with Superior, but the points noted above should ring enough alarm bells at the OTS, if severe supervisory action against this institution is not already underway.

Because Superior is an FDIC-insured institution, I am forwarding a copy of this letter and its enclosures to the Donna Tanoue.

Please call if there is any aspect of Superior that you would like to discuss.

Very truly yours,

Bert Ely

cc: The Honorable Donna A. Tanoue, Chairman, Federal Deposit Insurance Corporation

FDIC insured bank and thrift failures since 1995.
Dollars in millions

No.	Failure Date M	D	Year	Name	ST	Fund	Primary Regulator	Total Assets	Total Deposits	Estimated Insolvency Loss	Assets/ Loss	Fender Bender	Savings if loss % cut to 30%
1	1	20	1995	Guardian Bank	CA	BIF	Fed	277,481	193,600	20,989	7.6%		
2	3	3	1995	First Trust Bank	CA	BIF	FDIC	204,123	197,200	25,627	12.6%		
3	3	21	1995	Los Angeles Thrift and Loan	CA	BIF	FDIC	21,476	21,900	6,067	28.3%	Yes	
4	5	19	1995	Bank USA, N.A.	HI	BIF	OCC	9,361	8,900	2,593	27.7%	Yes	
5	7	28	1995	Founders Bank	CT	BIF	FDIC	77,417	72,700	10,374	13.4%	Yes	
6	7	28	1995	Pacific Heritage Bank	CA	BIF	FDIC	153,570	138,400	19,407	12.6%		
7	3	8	1996	Metrobank of Philadelphia, N.A.	PA	BIF	OCC	35,023	33,630	7,701	22.0%	Yes	
8	5	1	1996	People's Bank and Trust	TX	BIF	FDIC	19,981	18,788	3,378	16.9%	Yes	
9	6	14	1996	First National Bank of Panhandle	TX	BIF	OCC	62,719	57,905	16,038	25.6%		
10	7	12	1996	Fairfield First Bank & Trust	CT	BIF	FDIC	51,278	47,655	5,663	11.0%	Yes	
11	8	9	1996	Union Federal Savings Bank, FSB	CA	SAIF	OTS	35,140	32,189	14,000	39.8%		
12	8	16	1996	Commonwealth Thrift and Loan	CA	BIF	FDIC	12,731	10,250	5,640	44.3%		
13	11	21	1997	Southwest Bank	LA	BIF	FDIC	25,830	26,800	5,026	19.5%	Yes	
14	4	9	1998	Omnibank	MI	BIF	Fed	38,316	36,322	2,866	7.5%	Yes	
15	7	23	1998	BestBank	CO	BIF	FDIC	379,013	285,657	229,594	60.6%		115,890
16	8	7	1998	Q Bank	MT	BIF	Fed	14,406	13,097	1,590	11.0%	Yes	
17	3	26	1999	Victory State Bank	SC	BIF	FDIC	12,288	11,082	0	0.0%	Yes	
18	4	23	1999	Zia New Mexico Bank	NM	BIF	Fed	13,565	12,604	2,222	16.4%	Yes	
19	7	9	1999	East Texas National Bank	TX	BIF	OCC	113,860	100,470	8,632	7.6%		
20	7	9	1999	Oceanmark Bank, a FSB	FL	SAIF	OTS	62,956	63,427	1,343	2.1%	Yes	
21	9	1	1999	First National Bank of Keystone	WV	BIF	OCC	1,045,861	921,971	780,000	74.6%		466,242
22	9	10	1999	Peoples National Bank of Commerce	FL	BIF	OCC	34,790	33,558	3,094	8.9%	Yes	
23	11	11	1999	Pacific Loan and Thrift Company	CA	BIF	FDIC	69,294	107,198	47,224	68.2%		26,436
24	12	10	1999	Golden City Commercial Bank	NY	BIF	FDIC	88,244	81,268	0	0.0%	Yes	
25	1	14	2000	Hartford-Carlisle Savings Bank	IA	BIF	FDIC	113,311	71,337	11,127	9.8%	Yes	
26	3	10	2000	Mutual Federal Savings Bank	GA	SAIF	OTS	29,530	28,583	1,402	4.7%	Yes	
27	6	2	2000	Monument National Bank	CA	BIF	OCC	10,325	10,116	748	7.2%	Yes	
28	7	14	2000	Town and Country Bank of Almelund	MN	BIF	FDIC	26,014	25,657	3,605	13.9%	Yes	
29	9	29	2000	The Bank of Falkner	MS	BIF	FDIC	77,425	72,534	12,700	16.4%	Yes	
30	10	13	2000	The Bank of Honolulu	HI	BIF	FDIC	65,345	58,202	2,500	3.8%	Yes	
31	12	14	2000	National State Bank of Metropolis	IL	BIF	OCC	93,011	74,104	8,000	8.6%	Yes	
32	2	2	2001	First Alliance Bank Alliance B&T	NH	BIF	FDIC	18,400	17,500	119	0.6%	Yes	
33	5	3	2001	Malta National Bank	OH	BIF	OCC	9,500	8,800	80	0.8%	Yes	
34	7	27	2001	Superior Bank, FSB	IL	SAIF	OTS	1,765,455	1,606,214	750,000	42.5%		220,364
35	9	7	2001	Sinclair National Bank	AK	BIF	OCC	30,700	25,700	4,400	14.3%	Yes	
							Totals	5,097,739	4,525,318	2,013,749	39.5%		828,931

Note: A deposit insurance "fender-bender" is rather arbitrarily and liberally defined as (1) a failed institution with less than $50 million in assets and an insolvency loss percentage below 30%, (2) an institution with assets between $50 million and $100 million and a loss percentage below 20%, or an institution with more than $100 million in assets and an insolvency loss of less than $5 million.

BIF/SAIF Insolvency Losses Distributed by Loss Amount

35 Failures: 1995 to 9-7-01
$2.01 billion estimated cost

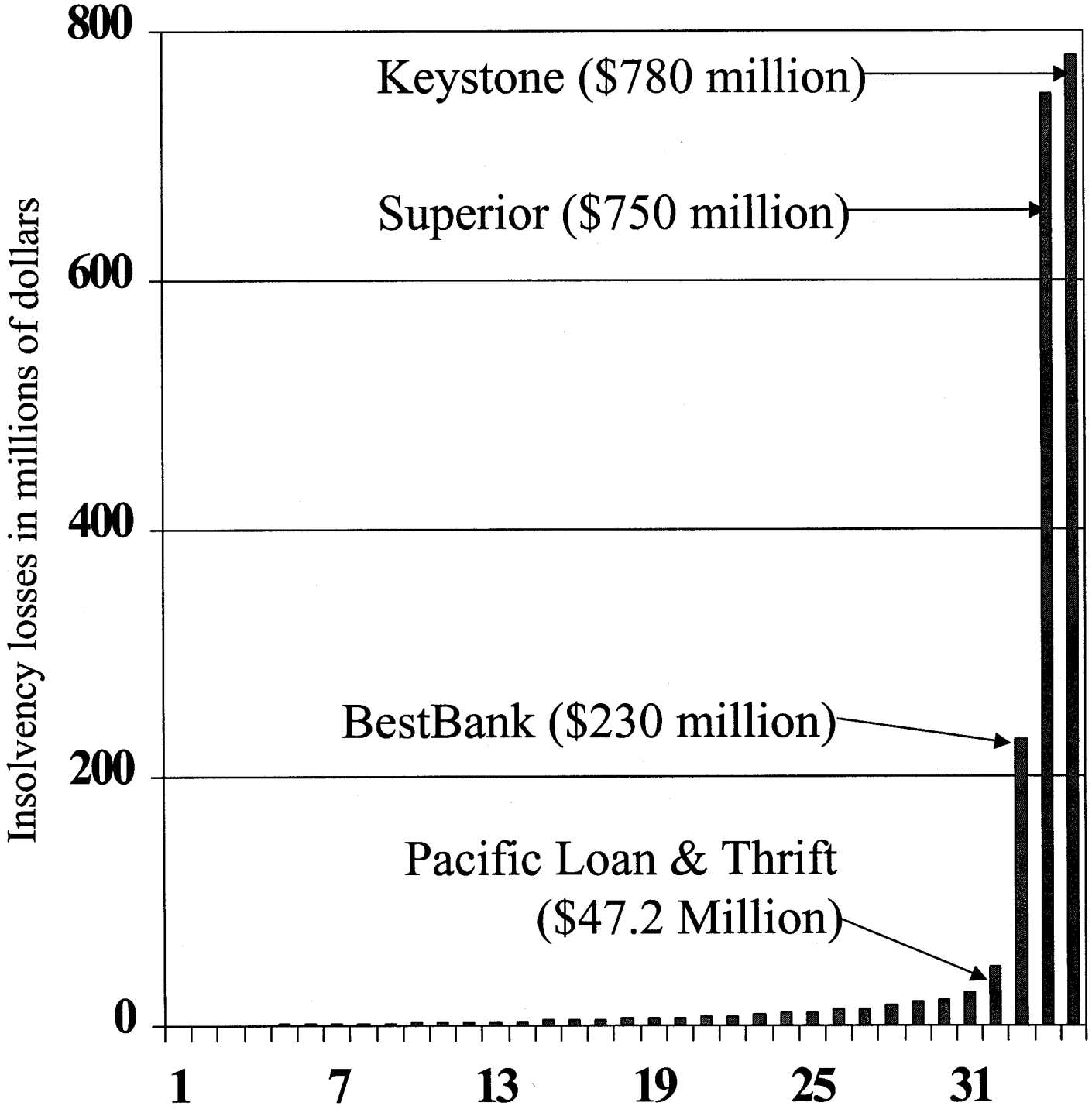


Figure 2

BIF/SAIF Insolvency Losses Stacked by Institution

35 Failures: 1995 to 9-7-01

$2.01billion estimated cost

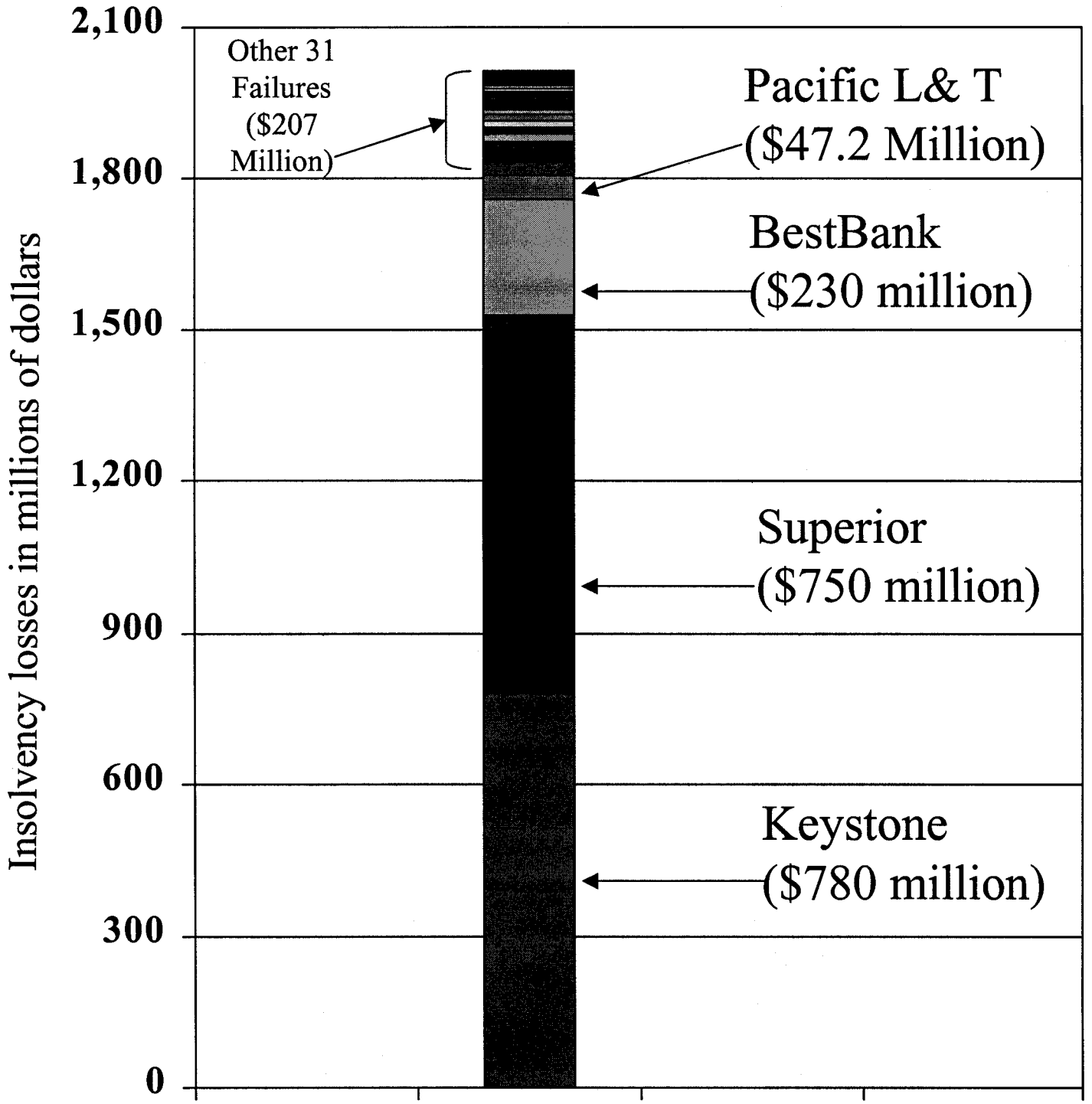


Figure 3

FDIC Insolvency Losses As a Percentage of Total Assets

35 Failures: 1995 to 9-7-01

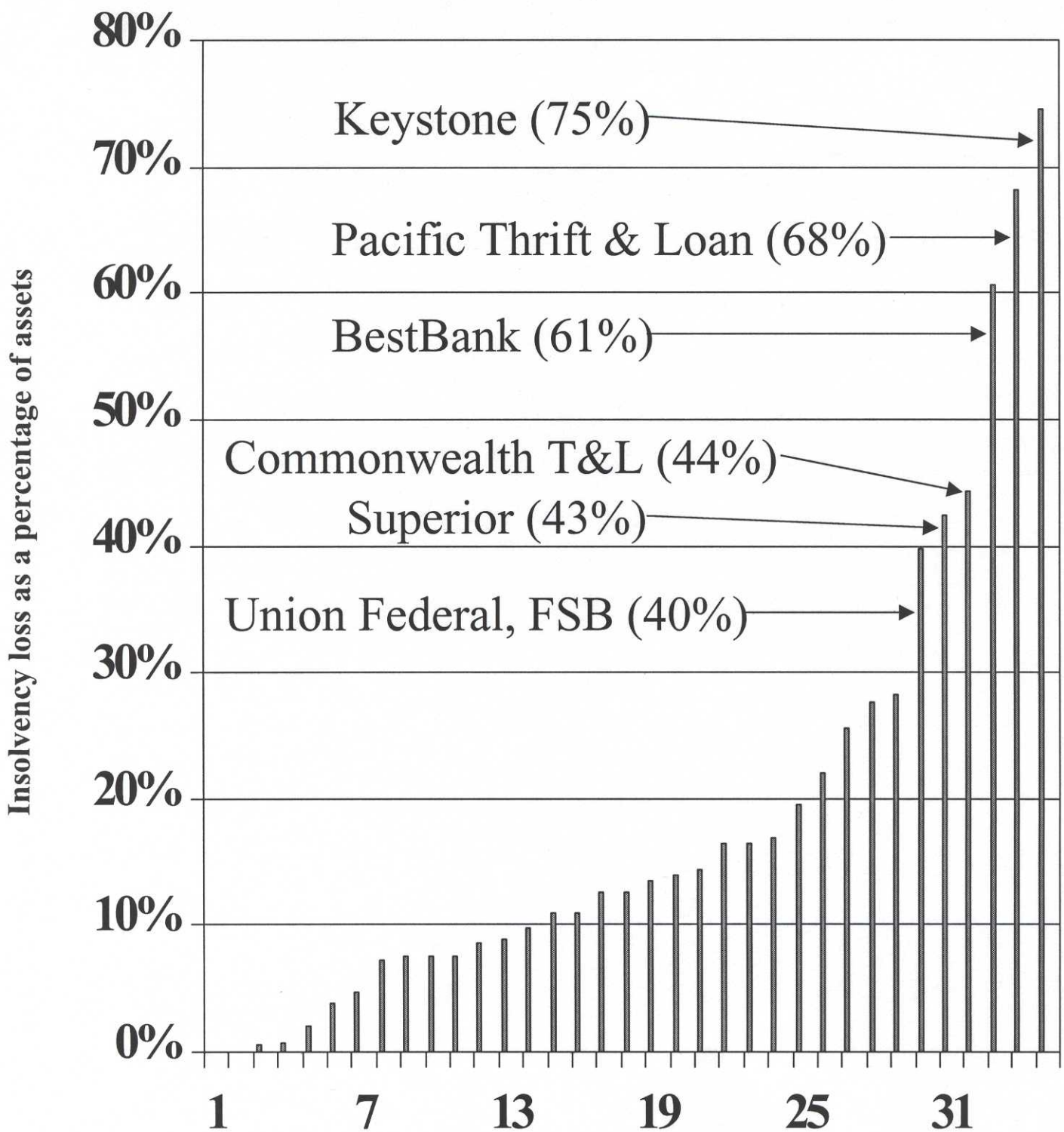
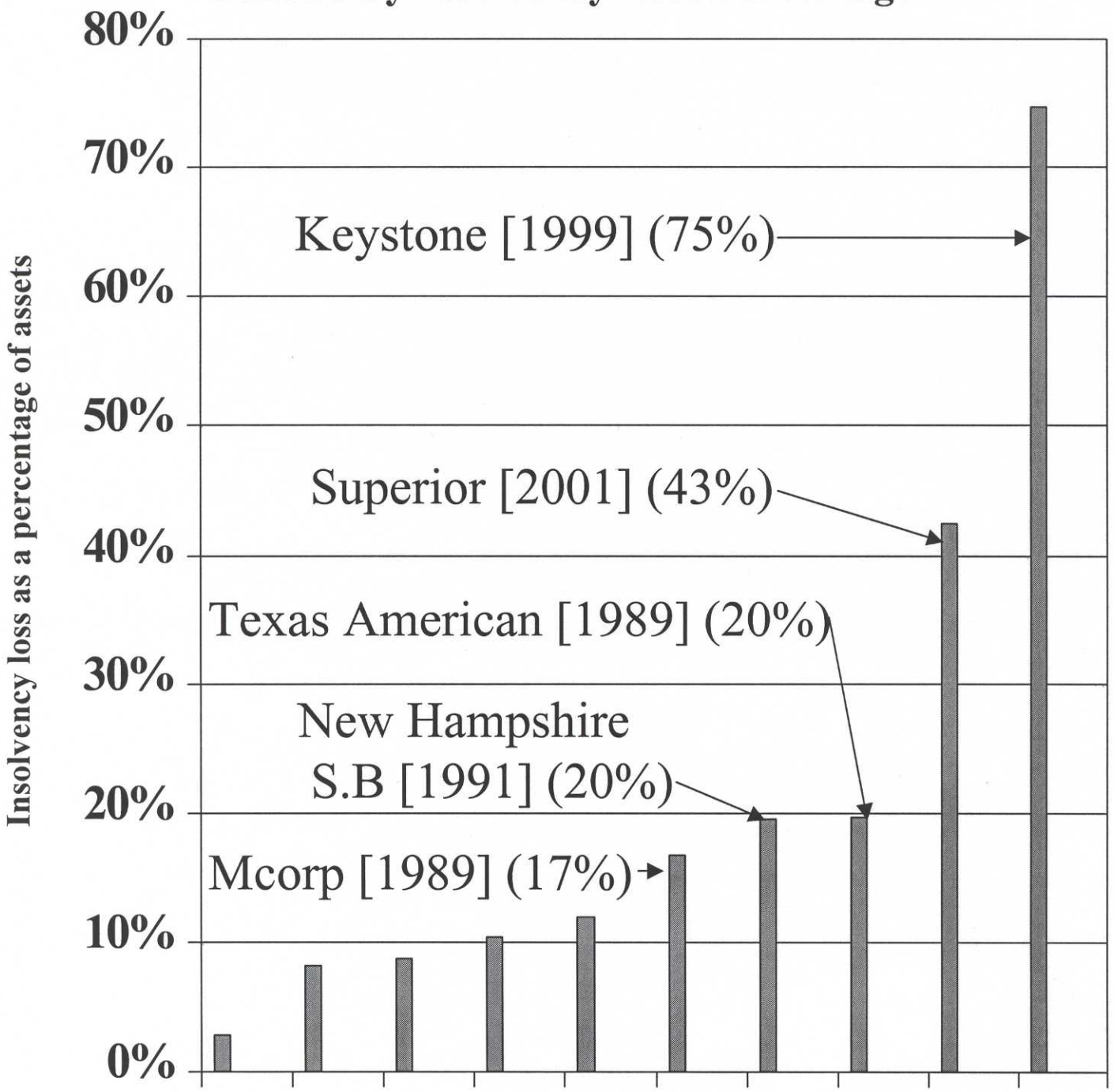


Figure 4

Ten Most Costly FDIC Bank Resolutions -- 1986-2001, Including Superior

Ranked by Insolvency Loss Percentage



Regulatory Moral Hazard

The Real Moral Hazard in Federal Deposit Insurance

BERT ELY

Many banking regulators, academics, and others hold that deposit insurance creates an undesirable moral hazard in banking. But the real moral hazard that federal deposit insurance creates is *regulatory moral hazard*. In this article I describe regulatory moral hazard, explain why depositor discipline of banks is highly undesirable, show how federal deposit insurance fosters regulatory moral hazard and propose a cross-guarantee concept for privatizing banking regulation so as to eliminate regulatory moral hazard in banking.

Moral Hazard

A moral hazard exists when a decision maker takes risks that he otherwise would not have taken, because the adverse consequences of the risk-taking have been transferred to a third party in a manner that is advantageous to the risk-taker and, more important, is disadvantageous and potentially even destructive to the party to whom the risk has been shifted. Insurance is such a risk-transferring device; therefore, the potential for moral hazard exists in any form of insurance, not just in deposit insurance. However, insurance presents a moral hazard only when it is underpriced or the insurance contract lacks sufficient safeguards for the insurer. A properly priced and carefully written insurance contract may actually cause an insured decision maker to take less risk or to be more conscious of the risks being taken than if he were uninsured. This

Bert Ely is the principal in Ely & Company, Inc., Alexandria, Virginia.

The Independent Review, v. IV, n. 2, Fall 1999, ISSN 1086-1653, Copyright © 1999, pp. 241–254

desirable result occurs when the insurer assesses and then monitors the insured's risk-taking and sets risk-sensitive premiums designed to deter unwise risk-taking by the insured. Hence, for example, we expect an insured auto driver to drive more safely than an uninsured one: the insured driver fears losing his insurance if he drives carelessly; the uninsured one has no such concern.

Insurance enterprises have operated successfully for centuries, with relatively few failures, because they have used pricing and contractual safeguards to reduce insurance's moral hazard sufficiently to enable insurers to earn the profits needed to attract the capital to support the insurance risks that they have assumed. Deposit insurance has been a notable exception, especially in the United States. Over the last 165 years, most state-run deposit insurance schemes have failed, as did the Federal Savings and Loan Insurance Corporation (FSLIC). However, three successful state deposit-insurance plans operated in Ohio, Indiana, and Iowa prior to the Civil War (Calomiris 1989, 15–19). Those three plans are historical precursors to the cross-guarantee concept discussed in the last section of this article. The relatively few deposit insurance programs in other countries have, in general, not fared much better than those in the United States.

Deposit insurance's moral hazard is rooted in the very rationale of deposit insurance. Quite simply, deposit insurance exists only because bank failures have caused losses to depositors. If banks (used here as shorthand for depository institutions of all types) never failed or, more realistically, if banks failed with no losses to depositors, then no political demand for deposit insurance would arise. Like any other economic good, deposit insurance is demanded only because consumers feel a need for it. The United States has had a richer experience with deposit insurance primarily because it has had so many bank failures, especially in the twentieth century, compared to other industrialized countries.

To identify the root cause of the moral hazard in deposit insurance, we must first explore the underlying causes of bank failures. By definition, a bank fails when, in going out of business, it imposes losses on its creditors, primarily its depositors and, before the Civil War, the holders of its circulating notes (currency issued by state-chartered banks). A bank that liquidates itself or is acquired by another bank without imposing any loss on its creditors is not a failed bank for the purposes of this article, even though it may have been approaching insolvency.

Banks fail for three reasons. First, bad management (poor internal controls, self-dealing, bad lending and investment decisions, excessively rapid expansion, and so forth) is the main cause of isolated or noncontagious bank failures. Second, an economic contagion, almost always triggered by a decline in the market value of assets, causes many banks to fail that in normal economic times would not. Third, government restrictions on asset and geographical risk dispersion limit the ability of individual banks to diversify their asset risk in order to protect themselves against

contagious events such as a regional asset deflation made worse by asset fire sales. In effect, asset and branching restrictions magnify contagion losses by increasing the number of bank failures. Classic examples of such compounding are the enormousness of the U.S. banking crisis of the early 1930s, when branching was highly restricted, and the great number of banking failures in the 1980s in Texas and other states that barred or severely restricted branching. The banking problems of the 1980s were further exacerbated by federally tolerated state restrictions on interstate banking and branching.

Prevention of bank failures has been a public-policy concern for as long as governments have chartered banks, because banks, which hold money balances (checkable deposits) and the most liquid savings of individuals and businesses, have been viewed as fiduciaries. The banking function has been a public-policy concern also because banks collectively operate the non-coin-and-currency payments system. Accordingly, politicians have long recognized that it is politically undesirable for depositors and holders of circulating notes to suffer temporary illiquidity and outright losses associated with illiquid or failed banks. Consequently, bank charters almost always have imposed basic safety-and-soundness requirements on bank owners, such as minimum capital requirements, investment and asset restrictions and prohibitions, and liquidity or reserve requirements, intended to ensure sufficient bank liquidity and to prevent bank failures. Government safety-and-soundness requirements are roughly comparable to the "best practices" that would otherwise be specified for banks and other types of fiduciaries. Separately, governments have also used banks to obtain interest-free loans from the public through reserve requirements and government bond collateral requirements for bank-issued currency.

Although safety-and-soundness requirements have always been attached to bank charters, deposit insurance is largely a twentieth-century phenomenon. Governments impose safety-and-soundness or insolvency protection requirements on just a few types of businesses besides banks. Specifically, solvency requirements have been imposed on insurance companies and on securities brokers and dealers for the same reason: to prevent their failure, or at least to ensure that certain classes of creditors, such as those insured by insurance companies, and the customers of securities brokers and dealers, do not suffer losses due to insolvency or fraud. Hence, the sole purpose of bank safety-and-soundness regulation is to ensure that banks do not fail at a loss to their depositors and other general creditors.[1] Some might argue that banking regulation serves only to protect taxpayers against the consequences of failed banks. However, taxpayers are at risk when banks fail only to the extent that they are taxed to

1. In 1993, Congress added a "depositor preference" provision to the Federal Deposit Insurance Act (12 U.S.C. sec. 1821(d)(11)) which gives domestic depositors (insured and uninsured) a higher liquidation priority in a failed bank than other general creditors, including depositors in the failed bank's foreign branches.

protect depositors in failed banks against loss (witness the savings-and-loan debacle). In fact, banking regulation exists to protect depositors against loss so that taxpayers will not have to protect depositors against loss.

Because it is unrealistic to trust bank owners to comply at all times with safety-and-soundness requirements, governments have enforced these failure-prevention schemes through a bank inspection or examination program complemented by banking supervision. Government banking supervisors intervene, formally or informally, in the management of a bank to prevent its failure. (That branching and asset restrictions increase the likelihood of bank failures, thus compounding the problems that banking regulators must deal with, is a political contradiction that American lawmakers, state and federal, ignored until recent decades.) Therefore, unlike the failure of other businesses, bank failure reflects regulatory failure. There are different kinds of regulatory failure, including restricting branch banking, encouraging institutions to borrow short and lend long (which did in the savings-and-loans), failing to identify problems in banks, sweeping known problems under the rug ("regulatory forbearance"), and others.

It is both reasonable and desirable for depositors and other bank creditors to rely on regulators to prevent bank failures and thereby to protect the creditors from illiquidity and principal losses. Banking regulators act as government-designated agents to prevent bank failures. Creditor reliance on bank regulators is reasonable also because regulators make the rules governing banking activities and then use their legal authority to obtain unique access to private information about every bank, including each bank's books, records about specific assets, and personnel records (on a real-time basis, if necessary). They can then use this information to assess the condition of every bank that they have chartered. Further, banking supervisors have the legal authority to intervene in a wide variety of ways, such as by issuing a cease-and-desist order to prevent a troubled bank from failing or, if the conditions leading toward failure cannot be reversed in time, by forcing the bank into liquidation or a merger with another bank before it plunges into insolvency.

In other words, banking regulators have both access to information and tools of enforcement that depositors, other bank creditors, and even minority shareholders lack. Only those who actually control a bank are on a par with regulators, and even that is not always the case; an organization that monitors and supervises many banks can be expected to have a better understanding of external threats to bank solvency—such as a looming asset deflation—than many bank managers, who may hold parochial or distorted views of the commercial marketplace in which they operate. Hence, bank regulators are the best positioned of all parties, apart from (or perhaps even including) bank managers, to prevent bank failures that create insolvency losses.

Depositor Discipline Is Highly Undesirable

It is desirable for depositors and other creditors to rely on regulators to prevent bank failures also because this arrangement represents a classic division of labor. That is, a banking regulator, as a government-mandated agent for depositors and other bank creditors, stands in their shoes as a monitor of banks. From a societal perspective, to rely on creditors to prevent bank failures or to second-guess the regulators is less efficient than to demand that regulators perform competently by preventing bank failures. Therefore, relying on "depositor discipline" is less efficient than relying on "regulatory discipline," because depositor discipline is premised on the notion that if regulators fail to do the job for which they are being paid, depositors should do that job for them. Robert Litan and Jonathan Rauch candidly acknowledge the unreliability of regulatory discipline: "Markets tend to be less forgiving than regulators, who may be more willing to give a troubled institution time to work through its problems" (1997, 118). However, the only practical way depositors can discipline a troubled bank is by withdrawing their deposits. Sleepy regulators, though, will not wake up unless enough depositors run away to create a liquidity crisis at the bank, which in turn creates the potential for contagion and a systemic financial crisis.

One apparent proponent of this logic is Gary Stern (1997), the president of the Federal Reserve Bank of Minneapolis. He argues, in effect, that large depositors in a failed bank should suffer a loss if they are too slow to wake up a sleepy regulator:

> Congress [in] 1991 legislation tried to make bailouts less likely by giving regulators new tools to close a troubled bank before large losses develop. *In practice, however, large, complex banks' financial fires are likely to burn for some time before regulators detect them.* The answer? Uninsured depositors should not receive full protection when a too-big-to-fail bank is rescued. (emphasis added)

A financial crisis, or even the threat of a crisis, wastes real resources. Advocating bank runs to wake up regulators is comparable to urging someone with a malignant brain tumor to operate on himself or to be prepared to intervene in his brain surgery if the surgeon starts to bungle the job. Perhaps a better analogy is the passenger on an airplane. Should passengers, who have no access to the airplane cockpit or the air traffic control system, nonetheless be held even partially responsible if the airplane in which they are riding crashes? The argument for depositor discipline raises this intriguing question: If depositors are fully capable of judging a bank's condition, why are banking regulators needed at all?

Mistakes will happen, though, and some banks will fail despite being closely regulated, just as even a highly competent surgeon will occasionally lose a patient on the operating table. In most businesses today, malpractice and product-liability

lawsuits as well as product and service warranties (which are insurance by another name) protect consumers from product and service defects. Banking regulation too is a business enterprise, because it provides a service—failure protection—that its customers (banks) pay for through examination fees. Therefore, it is only fair that bank creditors, who ultimately bear the cost of those fees, should be protected against regulatory failure, just as consumers increasingly are compensated, through lawsuits and payments under product warranties, for damages caused by incompetent professionals and defective products. In effect, because regulators are governmentally designated agents for depositors and other bank creditors, they must be liable for their errors, just as surgeons must be liable for their negligence.

Holding the government liable for its regulatory errors is not a completely foreign concept. In 1997 the federal government agreed to pay $25 million toward settlements that US Airways reached with survivors and victims' families after a 1994 crash because air traffic controllers, who are federal employees, contributed to causing the crash (Bloomberg News 1997). Notice that in this as well as in other airline crashes, no responsibility for the crash was attributed to the plane's passengers or their family members.

Bank regulators, as persons, and the government, as the owner and operator of the bank-regulation enterprise, traditionally have been exempt from malpractice lawsuits because of their "sovereign immunity"—the king can do no wrong. That notion reeks of self-interest. Instead, based on the product-liability analogy, if the government—and by extension the taxpayers—wants to conduct a bank-regulation business, it ought to assume the risks associated with that business, specifically, it ought to be liable to depositors for regulatory error, regardless of the cause or magnitude of the resulting bank failures. Because governments are loath to abandon sovereign immunity, a product warranty, in lieu of lawsuits against the government, is needed to protect depositors against losses in failed banks. Deposit insurance is that product warranty. That is, deposit insurance exists to protect depositors from regulatory error and incompetency, just as product warranties substitute for product-liability lawsuits in protecting, for example, car buyers from manufacturing flaws.[2]

But deposit insurance is not a free lunch; someone must pay for it. Although general tax revenues could be used to pay for regulatory error, within limits, it is much safer politically for elected officials to tax surviving banks to protect depositors and other bank creditors from regulatory failure. Banks do not generate much political sympathy, even though they pass on to their depositors, in the form of lower interest rates, the deposit insurance tax levied on them. Although called a premium, this levy in fact is a tax when the deposit insurance scheme is a government monopoly in which

2. Although federal deposit insurance was enacted as much to preserve unit banking as to protect small depositors, deposit insurance very effectively protected one form of bad regulation—branching restrictions—that is only now disappearing.

bank participation is mandatory. The FDIC is such a monopoly. Attempting to make FDIC premiums risk sensitive does not alter the fact that they are a tax to the extent that they are not truly risk sensitive—and in fact they are not.

Federal Deposit Insurance Fosters Regulatory Moral Hazard

Federal deposit insurance fosters regulatory moral hazard, or regulatory slackness, because the deposit insurance tax shifts the cost of regulatory error from depositors and taxpayers to the nation's surviving banks, which politically are less able than depositors and taxpayers to avoid paying the losses arising from bank failures. Consequently, because of the relatively small pain that the deposit insurance tax causes banks, up to a certain point regulators can afford to be less diligent than they would be if depositors or taxpayers in general paid for bank-insolvency losses. In this circumstance and in the absence of a banking crisis, regulatory diligence declines. In effect, it is the relative political ease of taxing surviving banks to cover bank-insolvency losses that arise from regulatory error that creates regulatory moral hazard.

Banks generally do not resist bearing the costs of regulatory failures that are imposed on them—in the form of both deposit insurance premiums and costly regulatory safeguards—if the risk-spreading benefits of deposit insurance, specifically the ability to operate with higher leverage (Ely 1997), significantly exceed the cost of regulatory failures. However, regulatory moral hazard consumes much of the benefit that deposit insurance, as insurance, conveys to banks, as evidenced by the banks' substantial loss of market share, in terms of assets held on-balance-sheet, to less regulated financial intermediaries such as mutual funds. By one estimate, banking's market share has dropped by half since the end of World War II (Kroszner 1999, 3). Mispriced deposit insurance and one-size-must-fit-all regulation increasingly create a substantial cross subsidy that flows from well-run to badly run banks. This cross subsidy arises because well-run banks are overcharged for their deposit insurance and, worse, are subject to excessive safety-and-soundness requirements, whereas badly run banks are undercharged for their deposit insurance and may be subject to insufficient safety-and-soundness requirements (Ely 1999a, 13–15). Even less onerous regulatory treatment for "well-capitalized" banks does not overcome the crudeness of one-size-must-fit-all government regulation and risk-*insensitive* pricing of deposit insurance.

The increased regulatory laxity fostered or subsidized by the deposit insurance tax represents the true moral hazard of deposit insurance. Worse, the federal deposit-insurance tax subsidizes regulatory laxity in all its forms: the incompetency and lack of accountability of regulatory officials; branching restrictions; and unwise but government-encouraged policies such as borrow short, lend long and the excessively risky lending prompted by the Community Reinvestment Act. Understandably, then, rational regulators would oppose any effort to increase depositor discipline on banks,

because the inevitable losses suffered by depositors who do not run fast enough from failing banks will create political pain for elected officials. Rational bankers also would oppose depositor discipline because the failure-protection safeguards that politicians will impose on banks that are explicitly subject to depositor discipline will be much more costly than the safeguards needed in a sound deposit insurance program.

Regulatory laxity can become excessive, though, as it did in the years leading up to the savings-and-loan crisis and as it almost did prior to the commercial banking problems of the late 1980s and early 1990s. Excessive laxity creates a situation in which the surviving institutions simply cannot pay, or can successfully resist paying, for the entire cost of regulatory failure. At that point the general taxpayers are tapped, usually by mortgaging future tax collections through government bond sales that raise sufficient cash to protect depositors and other creditors of failed banks. The funding of the U.S. savings-and-loan cleanup, the French government's multibillion-dollar bailout of Credit Lyonnais, and the bank bailout costs now hitting taxpayers in Japan and other Asian countries are excellent examples of the tax consequences of excessive regulatory laxity.

Regulatory moral hazard is costly even in benign economic times, and almost certainly its cost will rise in future years, for three reasons. First, there is the cost of the occasional bank failure. Second, and much more significant when few banks are failing (as at present in the United States), are regulatory compliance costs, specifically safety-and-soundness requirements, that politicians impose on banks to prevent excessive regulatory laxity. Third, the costs associated with regulations designed to curb regulatory laxity prompt creative people to engage in regulatory arbitrage by constructing lightly regulated channels of financial intermediation, such as money-market mutual funds, asset securitization, and hedge funds, that seemingly pose no risk of loss to creditors or taxpayers. The near collapse of Long Term Capital Management (LTCM) in the late summer of 1998 is an excellent example of regulatory arbitraging gone sour. In effect, regulatory arbitragers find it profitable to expend real resources to lawfully sidestep efficiency-impairing regulations. The growth of regulatory arbitrage may be a key reason why the financial sector of the U.S. economy has doubled its percentage share of the GDP over the last 50 years.

Electronic technology is raising the cost of containing regulatory moral hazard by destroying the efficacy of traditional banking regulation. New technology is making government's one-size-must-fit-all regulation increasingly unworkable, and therefore inefficient, as it facilitates regulatory arbitrage. Elected officials respond to this arbitraging by imposing additional costly regulatory burdens on the parties they can still ensnare in their regulatory net.

Numerous banking observers have implicitly, if not explicitly, recognized the problem of regulatory failure, but they have dealt with the problem by developing devices for sidestepping rather than eliminating it. They seek to fix the old jalopy rather than buy a new car. For example, Edward Kane (1997) has observed that

"regulators around the world energetically resist accountability," and he has considered "what kinds of regulatory schemes and truth-telling requirements might be used to improve accountability for regulatory performance" (147). Matthew Billett, Jon Garfinkel, and Edward O'Neal (1998) have observed that "the current regulatory structure may undermine the effectiveness of market discipline in deterring bank risk-taking. Moreover, the effectiveness of market discipline declines as a bank becomes more risky because riskier banks use more [government] insured deposits" (355). Many other commentators on banking regulation acknowledge at least by implication the inherent shortcomings of government banking regulation.

Proposals to remedy regulatory shortcomings generally reflect one of two approaches: reduce the riskiness of banks or increase the market discipline over banks to compensate for ineffective government regulation. The first approach often includes the "narrow bank" proposal for limiting a bank's assets to government debt or high-quality, short-term commercial paper. Litan (1987) presents the classic prescription for a narrow bank. However, the narrow-bank scheme merely shifts the potential for systemic instability, and the taxpayer bailout it may necessitate, to nonbank financial firms, as the LTCM fiasco demonstrated.

Requiring banks to sell more subordinated debt is another nostrum that has been offered to compensate for the shortcomings, or worse, of government regulators. Under this proposal the financial marketplace would signal to the regulators that a bank was weak if the yield on the bank's subordinated debt amounted to more than a specified percentage above the yield on U.S. Treasury debt of a comparable maturity, or if the bank could not keep enough subordinated debt outstanding because the markets refused to buy the debt at any price or kept "putting" it back to the bank, that is, seeking repayment at will. Joseph Haubrich (1998), an advocate of puttable subordinated debt, observes that some proposals, presumably including his own, "take important actions out of the regulators' hands. . . . The puttable debt drags the bank (and the regulators) into the public eye and thus increases accountability"(63). Charles Calomiris (1999), a vigorous advocate of subordinate debt discipline for regulators, recently observed that "government supervision and regulation, without any external market-derived pressure, are bound to fail" (34). But that statement begs the question, Why have government banking regulation in the first place?

Eliminating Regulatory Moral Hazard

Any attempt to eliminate regulatory moral hazard must first recognize that raising the standard of living is a major public-policy goal in the United States and most other countries. A key to boosting living standards is eliminating public policies that impose inefficiencies on business enterprises, including banks. Permitting the commercial marketplace to minimize moral hazards is one way to improve business efficiency. Essential to minimizing moral hazard is ensuring that the decision maker who causes a

moral hazard will bear the full cost of whatever hazards that decision maker has created. This notion, inherent in any form of privately provided insurance, can be applied to banking and deposit insurance.

Because banking regulation today is universally a government monopoly, only the political marketplace can limit the cost of regulatory failures. In effect, banking regulators do not benefit from the competitive pressures of the commercial marketplace that would force them to operate efficiently and to properly price their product, which is loss prevention. Proper pricing of a product, especially insurance, is essential for optimizing its usage.

Properly priced deposit insurance, that is, risk-sensitive premiums based on *leading* indicators of banking risk,[3] would eliminate the moral hazard commonly associated with deposit insurance because risk-sensitive premiums would induce banks to become better risk-takers, which in turn would optimize bank risk-taking for the entire economy. Properly priced deposit insurance would minimize regulatory moral hazard and the cross subsidy that it produces within the banking industry. However, a government monopoly can never properly price deposit insurance, because accurate pricing occurs only in private, competitive markets. Competing private regulators would not be able to get away with regulatory laxity, because well-run banks would seek to be regulated by more efficient regulators who charged premiums and imposed safety-and-soundness requirements that did *not* subsidize badly run banks. In effect, regulatory moral hazard exists today because federal deposit insurance and the regulations that accompany it are not subject to the forces of the commercial marketplace.

Proper pricing would also make a bank more sensitive to its own risk-taking than it would be if it operated without deposit insurance, because deposit insurance pricing, as opposed to changes in the bank's stock price, can reflect a bank's risk-taking more accurately and in a more timely manner. The highly leveraged nature of banking, which deposit insurance enhances, makes banks even more sensitive to their risk-taking. As with any other product or service, though, insurance (of any kind) can be properly priced only in a private, competitive marketplace. Hence, elimination of the regulatory moral hazard in deposit insurance requires that the business of banking regulation be privatized so that both bank regulation and deposit insurance can benefit from the forces of competition. The political marketplace ought to delegate to a properly structured commercial marketplace the responsibility for ensuring the sound operation of individual banks. Like many other activities, *ensuring the safe and sound operation of individual banks has become too important to the overall health of the economy to be left to government.*

3. Leading indicators of risk specific to a bank include internal control deficiencies, risk mismatches, and excessively heavy asset concentrations. The key external leading indicator of banking risk is a bank's credit exposure to an asset bubble.

The Cross-Guarantee Concept for Privatizing Banking Regulation

The "cross-guarantee" scheme (Petri and Ely 1995) represents one way, perhaps the only way, to successfully privatize banking regulation and deposit insurance. In a world of cross-guarantees, instead of being subject to government safety-and-soundness regulation and supervision, banks would contract for such regulation and its attendant product warranty. In effect, the cross-guarantee plan substitutes negotiated contractual regulation for one-size-must-fit-all government regulation. Contractual regulation is *not* deregulation or self-regulation. Instead, it represents a shift of the regulatory function from the government to the private sector by means of contracts tailored through negotiations to the circumstances of individual banks.

Specifically, each bank would negotiate with an ad hoc syndicate of voluntary guarantors (largely other banks) the prudent banking practices that the bank agrees to follow. The guarantors would select one of several competing private firms, called syndicate agents, to monitor the bank's compliance with the terms of its cross-guarantee contract; in effect, syndicate agents would replace government bank examiners and supervisors. The contract would also guarantee all deposits and almost all other liabilities of the bank against loss should the bank become insolvent. That guarantee would effectively serve as the contract's product warranty, thereby meeting the public-policy objective that banking regulation protect depositors and other bank creditors against bank insolvency losses. That protection would also produce another highly desired public good: a stable financial system (Ely 1999b). The guaranteed bank would pay a negotiated, risk-sensitive premium to its guarantors for providing their guarantee. A portion of the premium would be paid to the syndicate agent as a contract monitoring fee; the balance would compensate guarantors for the insolvency risk they assume on behalf of the bank's depositors and other guaranteed creditors.

The cross-guarantee concept has been incorporated into a comprehensive legislative proposal. H.R. 4318, a bill introduced by Representative Tom Petri in the U.S. House of Representatives on September 28, 1996, would utilize marketplace competition in three ways to improve the efficiency of banking regulation while minimizing moral hazard:

- Negotiating the prudent banking practices to which it will adhere would permit a bank to tailor those practices to its business strategy, but in a manner that minimizes its guarantors' risks. Today, one-size-must-fit-all banking regulation forces banks to follow herd-like and therefore suboptimal business strategies that periodically cause financial crises.
- Banks and their guarantors would negotiate premium-pricing formulas based on *leading* indicators of banking risk. The FDIC's risk-sensitive premiums are, for

political reasons, based on lagging measures of banking risk. This political reality was dramatically illustrated in early 1999, when the FDIC announced that it intended to raise the deposit insurance premium rate for well-capitalized banks with so-so managements (Barancik 1999a). Because of negative political reaction, the FDIC quickly backed away from that proposal (Barancik 1999b). In effect, cross-guarantee premiums would encourage a bank to incorporate in the interest rates that it charges the impact a particular risk is expected to have on its cross-guarantee premium. More accurate pricing of bank credit would lead in turn to more efficient use of that credit, which is highly desirable from a societal perspective.

- Because syndicate agents would compete for business on a contract-by-contract basis, they would have to monitor banking risks efficiently without alienating the banks they monitored or causing significant losses for guarantors. The competitive pressure on syndicate agents would be so severe that a major preventable loss to the guarantors of a failed bank could cause its syndicate agent to be fired as the monitor of other cross-guarantee contracts; a Barings- or Daiwa-type monitoring failure might even drive the syndicate agent for the failed bank out of business. One of the many failings of government banking regulation is that the regulators rarely suffer personally for insolvency losses among their charges.

In sum, the cross-guarantee proposal allows numerous constructive marketplace tensions to foster better banking regulation.

Further, the federal government would ensure that each cross-guarantee contract complied with explicit risk-dispersion rules designed solely to ensure that all losses incurred by guarantors in protecting the creditors of failed institutions remain entirely within the universe of guarantors, even in economic conditions far worse than the Great Depression. Preventing the failure of individual institutions would be the exclusive responsibility of guarantors and their syndicate agents. There are four risk-dispersion rules: (1) every guarantor must be guaranteed by a syndicate of other guarantors, thereby creating an interlocking web of guarantors; (2) each contract must have a minimum number of guarantors, no one of which can assume more than a specified amount of risk under the contract; (3) individual guarantors must be limited in the amount of risk they can assume under any one contract and in the aggregate; and (4) all guarantors must be subject to a uniform stop-loss rule that will spread all of a guarantor's losses beyond a certain level to its own guarantors and, if necessary, to additional levels of guarantors.[4]

4. Numerous articles and papers about cross-guarantees, as well as the Petri legislation, have been posted at http://www.ely-co.com.

Conclusion

Improvements in electronic technology increasingly reveal the inherent weaknesses of government banking regulation. The political marketplace has responded with even heavier regulation of those it can most easily regulate, specifically banks, while developing mechanisms that ensure, as a practical matter, that surviving banks and not the general taxpayer will pay for future deposit insurance losses. But this regulatory product warranty has become increasingly expensive for banks, thereby distorting the financial intermediation process by increasing the incentives for regulatory arbitrage. In effect, federal deposit insurance has augmented the societal cost of regulatory moral hazard. Only through the use of market mechanisms can regulatory moral hazard be eliminated. The cross-guarantee proposal represents one way, perhaps the only way, to apply market processes to eliminating regulatory moral hazard—the real moral hazard in federal deposit insurance.

References

Barancik, Scott. 1999a. FDIC Staff is Developing a System to Make Some Well-Capitalized Banks Pay. *American Banker,* January 4, p. 2.

———. 1999b. FDIC Puts Off Charging Riskier Banks More. *American Banker,* February 16, p. 4.

Billett, Matthew T., Jon A. Garfinkel, and Edward S. O'Neal. 1998. The Cost of Market versus Regulatory Discipline in Banking. *Journal of Financial Economics* 48:333–58.

Bloomberg News. 1997. *Washington Times,* May 15.

Calomiris, Charles. 1989. Deposit Insurance: Lessons from the Record. *Economic Perspectives* (Federal Reserve Bank of Chicago), May–June.

———. 1999. Market-Based Banking Supervision. *Financial Regulator* 3 (4):33–36.

Ely, Bert. 1997. Greenspan's Deposit Insurance Subsidy Argument Is Nonsense. *American Banker,* June 6.

———. 1999a. Banks Do *Not* Receive a Federal Safety Net Subsidy. *Financial Services Roundtable,* Washington, D.C., May.

———. 1999b. The Cross-Guarantee Concept: Eliminating Risk in the Interbank Markets. *Thirty-fifth Annual Conference on Bank Structure and Competition.* Federal Reserve Bank of Chicago, May.

Haubrich, Joseph G. 1998. Subordinated Debt: Tough Love for Banks? *Economic Commentary* (Federal Reserve Bank of Cleveland), December.

Kane, Edward J. 1997. Making Bank Risk Shifting More Transparent. *Pacific-Basin Finance Journal* 5:143–56.

Kroszner, Randall. 1999. Bank Regulation: Will Regulators Catch Up with the Market? Cato Institute briefing paper no. 45, March 12.

Litan, Robert E. 1987. *What Should Banks Do?* Washington, D.C.: Brookings Institution.

Litan, Robert E., with Jonathan Rauch. 1997. *American Finance for the 21st Century.* U.S. Department of the Treasury, November 17.

Petri, Tom, and Bert Ely. 1995. Better Banking for America: The 100 Percent Cross-Guarantee Solution. *Common Sense: A Republican Journal of Fact and Opinion,* Fall, pp. 96–112.

Stern, Gary. 1997. The Too-Big-to-Fail Problem. *Wall Street Journal,* October 6, editorial page.

Industry, Not Government, Is the Real Deposit Insurer

■ BY PETER J. WALLISON

It is not well known, even in the banking industry, that the federal government no longer stands behind what are generally called "insured deposits."

Since the Federal Deposit Insurance Corporation Improvement Act was adopted in 1991, it is the capital of the banking industry as a whole that backs up the promise to depositors that their savings are good.

Although the FDIC sticker is still on the door and Congress has passed resolutions that contain comforting language, in reality the federal government has no obligation to step in until the banking industry's capital has been exhausted. Even then it is doubtful that the full faith and credit of the United States have been effectively placed behind what are still called insured deposits.

This is true because the FDIC Improvement Act set up a system in which the FDIC has the authority, in effect, to levy taxes on the banking system — in proportion to the deposits in each bank — whenever the Bank Insurance Fund falls below 1.25% of total deposits. And if the FDIC believes that the condition of the industry is such that the fund could suffer substantial losses quickly, it has the authority to require additional premiums to provide a cushion against a large future claim.

The act even contemplates that a major loss or series of losses will exhaust the FDIC's fund too quickly for the banking industry to replenish it. In this case the law authorizes the FDIC to borrow up to $30 billion from the Treasury to meet its obligations, until it can collect the additional necessary premiums. Those would be used to rebuild the fund to at least the 1.25% level and to repay the Treasury.

What is unusual about this system is that the banks have no means of limiting their losses in advance, and that the FDIC has lost its incentive to limit losses. Before the FDIC Improvement Act, the agency did have an incentive: The size of its fund was limited, and if seriously impaired could be replenished only through many years of fixed annual assessments.

Once the FDIC acquired the authority to levy fees on the banking industry for immediate replenishment, this incentive disappeared.

A separation between those who bear losses and those responsible for preventing losses does not seem to be sound public policy. It is also a bit ironic, since the FDIC was established because of the moral hazard associated with deposit insurance. Now it appears that the FDIC, insulated from losses associated with its own administration, could be a source of moral hazard itself.

One way to address this problem is to change the deposit insurance system so that the banking industry establishes the loss-reduction policies that the FDIC enforces — especially those concerning bank examinations and insurance premiums. Through a properly administered system of risk-based premiums, backed up by a more comprehensive (and costly) program of examinations, strong and well-managed banks should be able to reduce the risks they face from weak and badly managed institutions. The additional costs of examinations would be more than offset by the prevention of losses from failures and bailouts.

Under such a plan the FDIC would remain the stakeholder for the insurance fund and the general manager of the system. The sticker would remain on the door. But the FDIC would levy and collect risk-based premiums, enforce rules and regulations, and employ examiners — all under policies established by the banking industry. An objection to this system is that it could clear the way for anticompetitive behavior or discrimination, especially in cases of competition between large and small banks. This is of course a possibility, but the legislation necessary to establish such a system would forbid and penalize anticompetitive behavior and would be enforced by the FDIC as administrator and arbiter.

There is in fact a good example of a self-regulatory system in which the industry has a large number of direct competitors of different sizes. The National Association of Securities Dealers, under the supervision of the Securities and Exchange Commission, enforces the fair-trading practice rules that are applicable to securities firms. Although the securities industry is as varied and differentiated as the banking industry, large and small firms have operated in this structure satisfactorily for more than 60 years.

After the savings and loan debacle of the late 1980s and the almost equally serious losses in the banking industry at that time, we should have learned that it is imprudent to allow some institutions to take risks while leaving those that will ultimately bear the losses without the means to control or prevent them. The good economic conditions that have prevailed since the FDIC Improvement Act was adopted should not obscure the fact that all well-managed banks — large and small — have a major stake in preventing future losses by the Bank Insurance Fund.

Mr. Wallison is a resident fellow at American Enterprise Institute in Washington.