

# CROSS GUARANTEES: A HORSE OF A DIFFERENT COLOR

*by Rep. Tom Petri and Bert Ely*

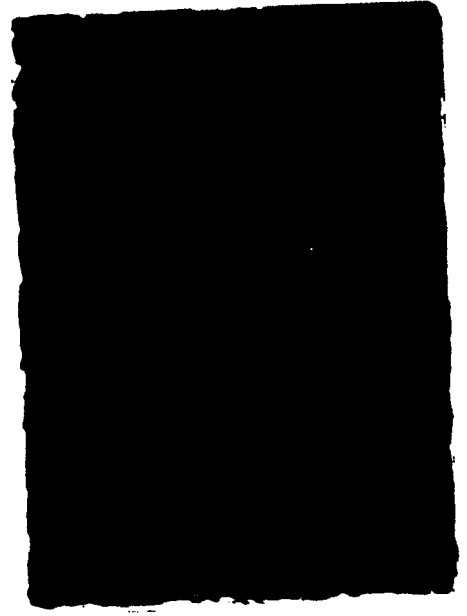
*Close your eyes and imagine a very different world than the one in which banks are governed by a federal deposit insurance system. Two prominent proponents of the cross guarantee system say it will make banking a business again while lessening the liability risk for bank directors.*



**B**anking is not a dying business. It only looks that way because federal regulation is strangling banking while favoring non-bank competitors with less regulation and lower tax burdens.



As Bill Seidman, former FDIC chairman and now publisher of *Bank Director* stated in the Fourth Quarter 1993 edition of *Bank Director*: "Banks are losing market share because regulatory burdens have made them



high-cost operators." He also could have said that banking regulations have made directors' and officers' insurance more expensive and made it harder for banks to recruit and retain directors.

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In fact banking is a good business, and one that is important to the American economy. However, it needs to be freed of its regulatory shackles so that banks and their directors can conduct their banking business without fear of another regulatory reign of terror that indiscriminately treats all bankers as incompetents and potential crooks, which unfortunately is the attitude that pervades FDICIA (the Federal Deposit Insurance Corporation Improvement Act of 1991).

The *raison d'être* for much of this banking regulation is federal deposit insurance. Therefore, there is little prospect of relief for banks and their directors without fundamental deposit insurance reform. Such relief would be provided by The Deposit Insurance Reform, Regulatory Modernization, and Taxpayer Protection Act of 1993 (H.R. 3570).

This bill would enact the 100% cross-guarantee concept for privatizing banking regulation and its attendant deposit insurance risk. It does *not* eliminate banking regulation; instead, it substitutes competitive, market-driven, customer-sensitive regulation for governmental edicts that often cause more problems than they solve. Market-driven regulation will, in turn, permit banks and thrifts to operate as real businesses, and not as

capital requirements, lending limitations, and other safety-and-soundness standards are almost as old as banking. But, banking regulation has never eliminated bank failures; in fact, banking has been swept by periodic panics that have seen scores or even hundreds of banks fail because they were insolvent, or perceived by the public to be insolvent.

In the absence of deposit insurance, depositors and other creditors bear the insolvency loss of a failed bank. Banking panics also can cause widespread economic distress as bankers dump their investments and call in loans to fund deposit runs. In effect, bank failures can cause two kinds of problems: cash losses to individual creditors of failed banks and impaired performance of an entire economy.

Banks, like any kind of business, should not be protected from failure, yet the consequences of widespread failures are understandably feared by politicians and the general public alike. Hence the perceived need for deposit insurance. This insurance not only protects widows and orphans, but it also inhibits banking panics that can damage the entire economy.

Deposit insurance attempts to isolate the depositor protection problem by focusing insolvency losses on a deposit insurer, and possibly on creditors of a failed

As Franklin Roosevelt observed during his first presidential news conference: "Government deposit insurance will guarantee bad banks as well as good banks, cost the [taxpayer] money, and put a premium on unsound banking in the future." In other words, it is government regulation and a government-run insurance program that is banking's problem, not regulation and deposit insurance, per se.

### **The failings of government regulation and insurance**

Government banking regulation/deposit insurance has an inherent, irreparable failing that is the root cause of its problems: It is a government monopoly. Monopolies can never deliver goods and services as efficiently or as effectively as private, competitive markets for the simple reason that competition spurs better performance because customers can decide with whom they will do business. Suppliers who perform badly, give poor service, or treat their customers in a high-handed, officious manner simply do not get the business, and fail, as they should.

Government regulatory monopolies are even worse than private monopolies, for several reasons. First, government monopolies rely on uniform rules and regulations, rather



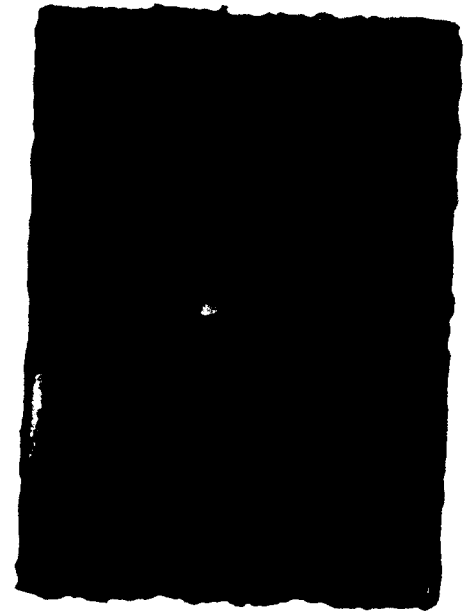
extensions of the federal government.

### **The deposit insurance problem**

Government banking regulation did not just happen; it has evolved over several centuries. Its principal rationale has been to prevent the failure of individual banks. Hence,



bank who supposedly can be stuck with their share of the loss without causing a banking panic. Bank regulation then becomes a tool for minimizing the deposit insurer's loss. So far, so good. The problem arises when *government* regulators, using government's police powers, attempt to prevent losses suffered by a *government* deposit insurer.



than custom-tailored and mutually agreed upon contractual terms, to influence the behavior of their "customers." Given the legitimate notion that all persons must be treated equally before the law, government regulations become "one-size-must-fit-all" rules that barely fit anyone at all.

In a fast-moving and complex financial world, government regulations increasingly

distort banking as they lag behind rapidly changing realities. As Rupert Pennant-Rea, the Deputy Governor of the Bank of England, readily admitted recently to a group of bankers, regulators are always five years behind, and that is good, according to Pennant-Rea, for if regulators tried to stay abreast of technology, they would stifle innovation. Of course, this delay means that government regulators will always lag in evaluating new risks that should be addressed in a more timely manner.

Second, government regulatory monopolies cannot use the pricing mechanism as a tool to influence customer behavior in ways that optimize economic performance. Prices, like other contractual terms, can be properly determined only in private, competitive markets where both buyers and sellers have choices. Banks have no choice, however, if they are dealing with a government regulatory and insurance monopoly.

The FDIC has implemented what it calls "risk-sensitive" insurance premiums, but they lack true risk sensitivity because of

another failing of government monopolies: The politically powerful who are unhappy with how the monopoly has treated them will squawk, and get political relief. Understanding this reality, the FDIC pulled its punch and implemented premium rates designed not to offend. Hence, the power of pricing to promote good economic behavior and deter bad behavior will always be lacking in a government insurance monopoly, such as the FDIC.

Accurate, market-driven pricing is especially important in banking because the risk of insolvency to a deposit insurer should be incorporated in the interest rate a bank charges on every loan it makes. Properly pricing this insurance risk not only protects the insurer but also promotes the much greater social good of ensuring that the bank is extending credit in a manner that will not later cause broad economic distress. To a great extent, badly priced deposit insurance was the root cause of the recent, and still lingering, commercial real estate crisis. Like any other economic good, though, insurance

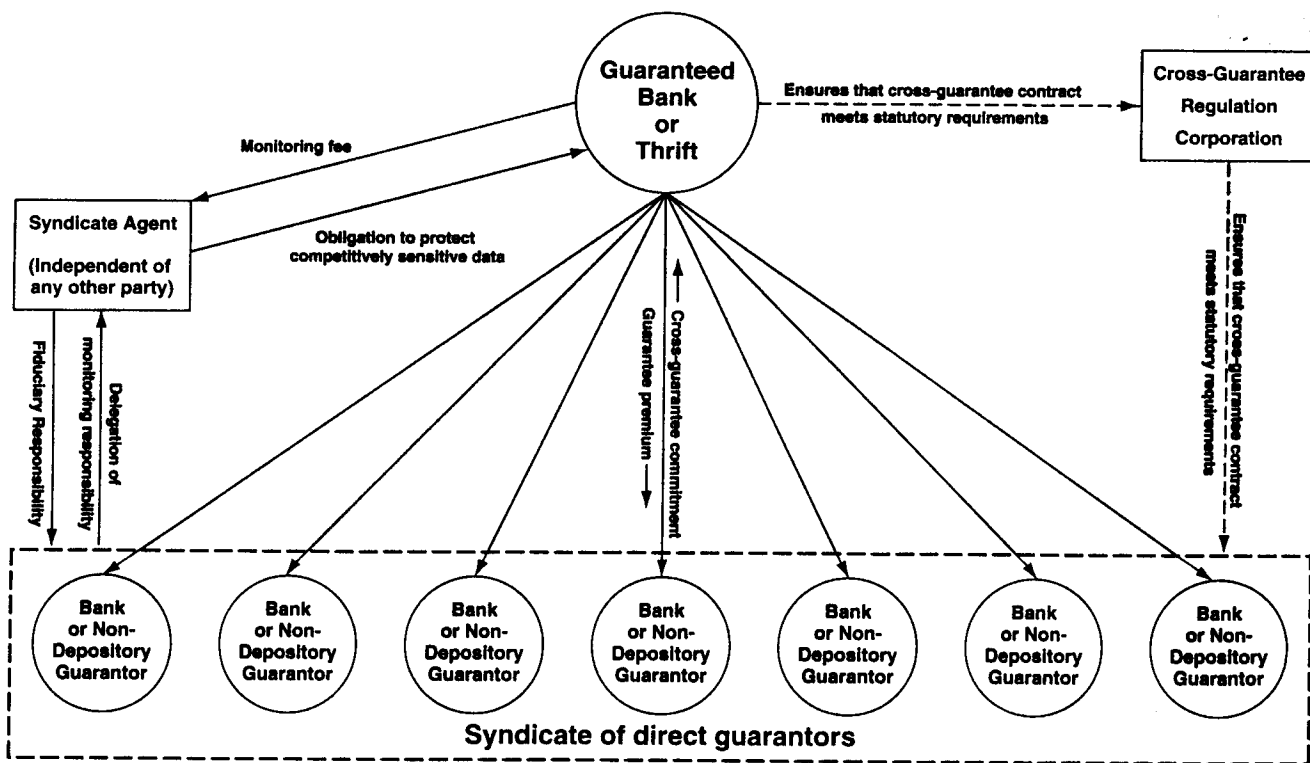
can only be priced properly in a competitive, and therefore, private marketplace.

Third, government rule-making, by its very nature, is a highly politicized process that often produces unintended consequences worse than the problem that a particular rule or dictate is attempting to solve. Often these rules are simplistic or ignore economic realities. Two examples will illustrate.

Uniform capital regulations assume that all banks and thrifts have the same risk profile, yet banks and thrifts differ greatly in their appetites for and ability to manage risk. Further, some believe that whatever ails deposit insurance can be cured by imposing higher capital standards on banks and thrifts. Yet higher uniform capital standards serve primarily to drive out of banks and thrifts lower-risk assets that the marketplace says do not need as much capital backing. Consequently, the financial markets have become active securitizers of these lower-risk assets.

After the Great Depression, the federal government encouraged S&Ls to ignore economic reality by engaging in an extreme form of maturity-mismatching; that is, using short-

Figure 1: The Parties To A 100% Cross-Guarantee Contract



term, readily withdrawable passbook savings to regulate long-term, fixed-rate home mortgages. This worked only in a stable interest rate environment, yet the world is hardly stable—particularly when the country has a central bank, the Federal Reserve, that set America up for record-high interest rates in the early 1980s by depressing real rates of interest in the 1970s. Understandably, then, the S&L industry was a disaster waiting to happen by 1980 when interest rates jumped.

### The cross-guarantee solution

Regulation and deposit insurance are not the problems for banking. Government regulation and government deposit insurance are the problems. Until now, though, a safe-and-sound private sector alternative has not existed. Numerous private sector deposit insurance schemes have been tried, but, with three noteworthy exceptions, these schemes failed because they neither priced properly nor diversified adequately the insolvency risk they assumed; worse, they relied on government regulators to keep banks on the straight-and-narrow.

The three exceptions, the deposit insurance mechanisms that operated in Ohio, Indiana, and Iowa before the Civil War, are antecedents of a sort for the cross-guarantee concept for privatizing banking regulation and its attendant deposit insurance risk. Unfortunately, federal banking legislation enacted during the Civil War effectively snuffed out these three plans, thus aborting the development of a protection mechanism that might have evolved into the cross-guarantee concept reflected in The Deposit Insurance Reform, Regulatory Modernization, and Taxpayer Protection Act of 1993 (H.R. 3570). As veteran banking consultant Carter Golembe once observed, when Congress enacted federal deposit insurance in 1933, over the strong objections of President Roosevelt and others who knew better, it modeled the FDIC on the many state deposit insurance plans that failed by then rather than on the three that worked. Such is the wisdom of Congress.

The cross-guarantee concept sounds complex, or even alien, largely because it relies on market forces, rather than government edicts, to promote safe-and-sound banking.

H.R. 3570 creates a marketplace in which banks and thrifts will freely negotiate contracts that guarantee all of each institution's deposits and most of its other liabilities against loss should the institution become insolvent. Most of the guarantors under these contracts will be other banks and thrifts who have voluntarily agreed to be guarantors under a particular contract. Hence, the term "cross-guarantee" describes a system which essentially is an industry self-insurance mechanism. To broaden the pool of potential guarantors, the bill also authorizes non-depository guarantors, such as industrial corporations, university endowment funds, and very wealthy individuals.

Figure 1 illustrates the parties to a typical

lower premium rates for most banks than will be likely under federal deposit insurance. Second, market-driven regulations will be much less costly to comply with than inappropriate government regulations.

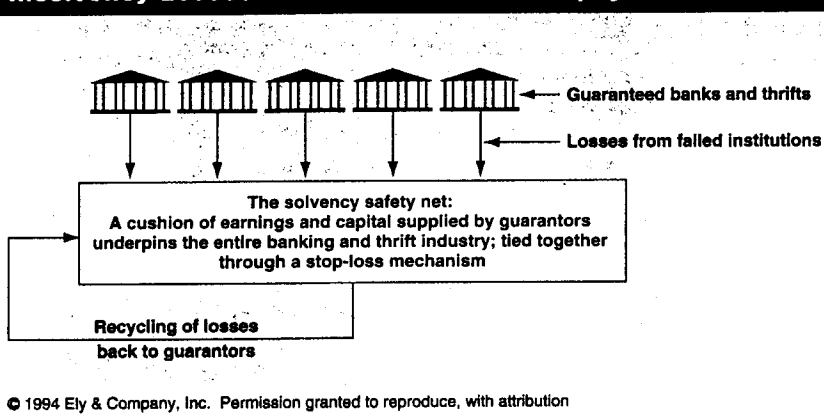
Working through an independent, private-sector "syndicate agent," the guarantors will be able to monitor the guaranteed institution's compliance with the safety-and-soundness provisions set out in its cross-guarantee contract. *These provisions will completely replace the government safety-and-soundness regulations under which banks and thrifts now operate.* Hence, these provisions will reflect the business strategy the bank or thrift has selected; no longer will government regulation dictate banking strategies. Employees of the syndicate agent, sensitive to the needs and interests of both the guaranteed institution and its guarantors, will replace officious government bank examiners.

Of course, if the syndicate agent bungles or the guarantors fail to respond in a timely manner to danger signs flashed by the guaranteed institution, and it becomes insolvent, the guarantors may suffer a loss. Under no circumstance, though, will the federal government attempt to prevent

the failure of an individual institution or protect guarantors and syndicate agents from their own follies. Of special importance to bank and thrift directors, H.R. 3570 bars guarantors from using the FDIC's extraordinary powers to sue directors for mistakes the guarantors or the syndicate agent made in overseeing the activities of a failed bank or thrift. The buck will stop with the guarantors.

Government regulation of the cross-guarantee marketplace will focus only on maintaining the stability of the entire banking system. Specifically, H.R. 3570 creates a small regulatory agency, the Cross-Guarantee Regulation Corporation (CGRC), to oversee the cross-guarantee marketplace. The CGRC will approve every cross-guarantee contract before it takes effect, but only to ensure that the contract meets certain statutorily prescribed risk-dispersion requirements designed solely to ensure that no failure of an individual institution will shake people's faith in the strength of the cross-guarantee system or cause Congress to be concerned about having

**Figure 2: Under 100% Cross-Guarantees, Bank and Thrift Insolvency Losses Will Not Reach The Taxpayer**



cross-guarantee contract. Under the bill, an ad hoc syndicate of guarantors will assume almost all of the guaranteed institution's insolvency risk, thus eliminating any need for depositor discipline. By protecting all deposits, the cross-guarantee system also eliminates the discrimination thousands of small-enough-to-liquidate banks and thrifts experience under the too-big-to-fail reality of the industrialized world.

In return for providing insolvency protection, the guaranteed institution will pay its guarantors a premium or guarantee fee that will be determined under the terms of the contract. Presumably, this risk-sensitive premium, based on leading indicators of banking risk, will reflect the guaranteed institution's insolvency risk more accurately and timely than the FDIC's supposedly risk-sensitive premiums can ever hope to do. The net cost of cross-guarantees, including related compliance costs, should be much lower for banks and thrifts than the present cost of being federally regulated and insured, for two reasons. First, lower bank insolvency losses under the cross-guarantee system will lead to

to use taxpayer funds to bail out the system, as happened with federal deposit insurance.

The following, reasonably straightforward rules, which the CGRC will enforce, will effectively construct a "solvency safety net" under the entire banking system that will be stronger financially than our increasingly indebted federal government:

◆ Every guarantor must itself be guaranteed by other guarantors. This inviolate requirement automatically constructs the solvency safety net that is then strengthened by the following requirements.

◆ Each guarantor will benefit from a uniform "stop-loss" rule that will pass all of its losses as a guarantor over a certain limit through to its own guarantors. This loss pass-through will spread a large insolvency loss widely but thinly across the solvency safety net, thus ensuring that no loss will puncture this safety net, even in conditions worse than the Great Depression. The stop-loss limit has been set so that no guarantor will fail by virtue of being a guarantor.

◆ The insolvency risk posed by each cross-guarantee contract will be spread over many guarantors. For example, any bank or thrift with more than \$10 billion of assets must have at least 100 guarantors, no one of whom can assume more than one percent of the risk under that contract.

◆ Each guarantor will be limited as to the maximum amount of risk it can assume under any one contract and in the aggregate. Using premium income as a proxy for the risk assumed, a guarantor's total premium income from all of its cross-guarantee contracts on an annualized basis cannot exceed 3% of its equity capital.

Together, these provisions will create a puncture-proof solvency safety net under all banks and thrifts, as illustrated in Figure 2. Strictly as a political facade, the bill creates a backup fund (BUF), that would honor the present federal deposit insurance commitment. However, no loss should ever reach the BUF. If such an event did occur, the federal government already would be defaulting on its own obligations because a horrendous disaster, such as a major East Coast earthquake or a large meteor strike, had devastated the American economy.

The cross-guarantee system is premised on harnessing market forces to deliver safe and sound banking to America. The transition to cross-guarantees reflects that philosophy. The cross-guarantee system, if enacted,

will not activate unless at least 250 banks and thrifts with at least \$500 billion of assets have first *voluntarily* obtained contracts approved by the CGRC. Only if this critical mass is reached, will the system activate.

If most banks and thrifts decide government regulation is preferable to the cross-guarantee system (certainly a dubious proposition), then not enough banks and thrifts will obtain contracts, and the system will not activate. Once it does, though, banks and thrifts will have up to eight years (for the smallest institutions) to become guaranteed institutions. Those not able to obtain a contract (which should be very few because of FDICIA) will effectively have failed. They will immediately be taken over by the FDIC.

### **The many payoffs from cross-guarantees**

The cross-guarantee system will be a win-win proposition for banking and for the economy because it will promote sounder and more efficient banking that will properly reward good bankers, and their stockholders/directors, while discouraging bad banking practices that hurt everyone.

Risk-sensitive cross-guarantee premiums, based on leading indicators of banking risk, will jump for credit being used to inflate speculative bubbles that later will burst, causing great losses to lenders and their insurers and guarantors. In fact, had cross-guarantees been implemented years ago, America would not have experienced the recent, painful recession that it slowly exited. Specifically, cross-guarantee premium rates would have significantly reduced the amount of credit made available during the 1980s to developers of unneeded commercial real estate.

Cross-guarantees also will improve the efficiency of the financial system by eliminating incentives the marketplace now has to engage in "regulatory arbitrage;" that is, using electronic technology to lawfully circumvent banking regulation, specifically uniform capital regulations. Regulatory arbitrage has been the primary incentive driving the growth of mutual funds, the commercial paper market, asset securitization, hedge funds, and derivative products. In effect, market-driven regulation of the cross-guarantee system will quickly eliminate the regulatory inefficiencies that foster such arbitrage. By escaping from regulatory inefficiency, banks and thrifts will be able to recapture much of the market share they have lost in recent years.

In particular, the credit enhancement provided by the cross-guarantee system (all guar-

anteed institutions will be AAA+++ rated) will permit banks and thrifts to profitably lend to low-risk borrowers, such as high-quality corporations and home owners. No longer will banks and thrifts feel compelled to securitize their higher quality assets. Under cross-guarantees, they will be able to keep them in portfolio.

While the cross-guarantee system will benefit banks and thrifts of all sizes, it will be especially beneficial for smaller institutions, for two reasons. First, the bill requires that cross-guarantee contracts protect *all* deposits, and not just the first \$100,000. This provision means that large depositors in small banks will not fear losing some of their money if their bank fails. Second, compliance costs for smaller banks and thrifts will drop substantially because competition will produce cross-guarantee contracts for smaller banks that will be much simpler than the existing regulations under which these banks and thrifts must now operate.

Cross-guarantees also will give banks greater operational freedom to pursue unique business strategies. One societal benefit of this freedom is that some banks will find it worthwhile to adopt an operating style suitable to serving low-income and minority communities. No longer will the federal government have to stiffen one set of regulations, the Community Reinvestment Act, to neutralize the growing negative effects of another set of regulations, one-size-must-fit-all safety-and-soundness standards.

### **Getting to cross-guarantees**

H.R. 3570 has been developed to the point that we are confident it will work financially and legally. That is the easy part. The hard part is enacting it, for it will reverse the growing politicization of the banking system. In effect, the bill will dramatically shift power over banking and credit allocation from the political process to the marketplace. This shift will be good for the country, and for banking, but bad for those inside the Washington Beltway who seek to direct the credit allocation process or otherwise profit from the heavy hand of government banking regulation. Consequently, those who will lose power or money under this reform will vigorously oppose it.

H.R. 3570 will become a reality only if bankers take the lead in building grassroots support for this escape hatch from increasingly irrational and harmful government regulatory micromanagement of banking. Can bankers meet this challenge? **BBB**