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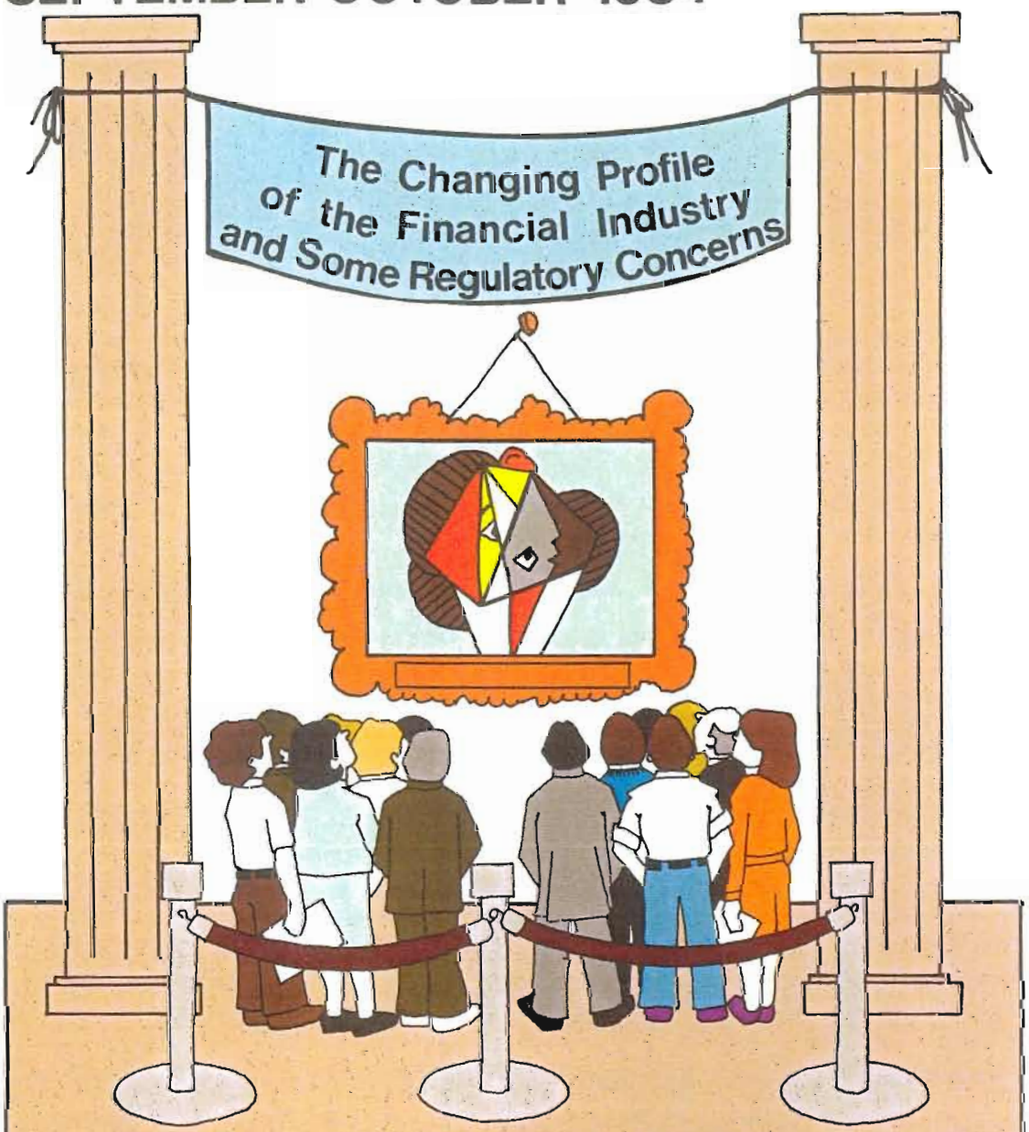

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THE CHANGING PROFILE OF THE FINANCIAL INDUSTRY AND SOME REGULATORY CONCERNS

Recent legislation has lifted many regulations that had stood for fifty years, and has authorized new powers for financial institutions. Banks, thrifts, and other firms have begun to adapt to this environment, and they are using their new powers to reshape the industry's profile. At the same time, the institutions charged with regulating the financial industry are also adapting. The articles in this issue of the *Business Review* examine some of the concerns of regulators in light of the emerging profile of the financial industry. Mark J. Flannery and Aris A. Protopapadakis consider recent proposals to revamp federal deposit insurance by replacing some of the regulation with premia priced to reflect banks' risk. Finding this approach not significantly different from or better than the present system, they also identify other means of increasing banks' responsiveness to risk. Janice Moulton looks at the expanded loan powers authorized to thrifts, and, focusing on Pennsylvania, describes the implications of increased competition for bank merger analysis.

RISK-SENSITIVE DEPOSIT INSURANCE PREMIA: SOME PRACTICAL ISSUES

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ANTITRUST IMPLICATIONS OF THRIFTS' EXPANDED COMMERCIAL LOAN POWERS

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The Federal Reserve Bank of Philadelphia is part of the Federal Reserve System—a System which includes twelve regional banks located around the nation as well as the Board of Governors in Washington. The Federal Reserve System was established by Congress in 1913 primarily to manage the nation's monetary affairs. Supporting functions include clearing checks, providing coin and currency to the banking system, acting as banker for the Federal government, supervising commercial banks, and enforcing consumer credit protection laws. In keeping with the Federal Reserve Act, the System is an agency of the Congress, independent administratively of the Executive Branch, and insulated from partisan political pressures. The Federal Reserve is self-supporting and regularly makes payments to the United States Treasury from its operating surpluses.

Risk-Sensitive Deposit Insurance Premia:
Some Practical Issues

*Mark J. Flannery and Aris A. Protopapadakis**

Federal deposit insurance emerged in the United States in 1933, following a widespread loss of confidence in the banking system which precipitated an unprecedented number of bank failures. The mood of the day was one in which one bank's demise tended to generate concern that others would fail. Accordingly, depositors would "run" on their banks in an effort to withdraw funds while there was still time. Such a banking "panic" could *cause* an otherwise sound bank to fail. Congress sought to restore public confidence in financial institutions by creating public deposit insurance corporations, which substituted the credit of the federal government for the credit of individual private banks. Federal deposit insurance virtually eliminated bank panics, but it introduced another type of inefficiency. In particular, the way deposit insurance is priced induces insured institutions to take on an excessive amount of risk. To counteract

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this influence on banks' choices of investments, the federal insurance agencies have imposed a system of restrictive regulations designed to limit insured institutions' risk-taking.

An optimal insurance system would eliminate the possibility of banking panics without distorting the insured banks' investment decisions. The extent to which our present deposit insurance system achieves these two objectives is a debated issue. Many bankers (and others) contend that existing regulations unduly restrict their ability to undertake reasonable risks. On the other side, the insurance agencies tend to feel that their traditional regulations have become insufficient to the task of controlling bank risk-taking in today's financial environment. As a result, there is growing support for reform of the current deposit insurance system.

One prominent view of appropriate reform would have the federal agencies set deposit insurance premium rates to reflect each institution's risk, as many types of private insurance do. Such "risk-sensitive premia," it is claimed, would lessen, or even eliminate, bankers' incentives to take on excessive risks, and they would allow restrictive regulations to be reduced. The two largest federal insurance agencies (Federal Deposit Insurance Corporation (FDIC) and Federal Savings and Loan Insurance Corporation (FSLIC)) recently have expressed their support for changing the way their insurance premia are set. FDIC has gone so far as to propose a specific plan for charging higher insurance premia for banks with larger exposures to certain types of risks.

Designing an optimal U.S. deposit insurance system is a very complicated problem, to which we have no easy solution. We do, however, offer some important observations about the extent to which risk-sensitive premia *set by a federal insurance agency* can be expected to replace successfully the current system of regulatory restrictions. Though the concept of risk-sensitive premia is theoretically appealing, some of its proponents may have exaggerated the net effect this reform would have on private financial decisions. Rather than allowing the federal government to *withdraw* from influencing private financial decisions, the introduction of risk-sensitive premia would simply require a *different type* of intervention. The difficulties associated with implementing a system of risk-sensitive federal insurance premia make it unlikely that such a system would be superior to the current system of restrictive regulations. Instead, the federal insurors might have to rely more on the private sector for controlling bank risk-taking in the current financial environment.

FIXED-PREMIUM DEPOSIT INSURANCE AND BANK RISK-TAKING

Currently there are three federal insurance agencies: FDIC for commercial and mutual savings banks, FSLIC for savings and loan associations, and the National Credit Union Share Insurance Fund (NCUSIF) for credit unions. Because each agency faces similar problems, we will refer to them collectively as the "federal insuror," and although there are several types of insured institutions, we will call them all "banks."

The federal insuror currently charges all banks the same premium rate, regardless of their financial condition. In return, the agency insures certain types of bank deposits against loss in the event of a bank's failure. Despite a statutory limit on its liability to a failed bank's depositors, the insuror has acted in the majority of cases to protect all liability-holders via a transaction called "purchase and assumption" in which a solvent institution *purchases* some or all of the failed bank's assets and *assumes* its outstanding (insured *and* uninsured) liabilities (see CURRENT FDIC INSURANCE PRACTICES). The net result is that most or all bank liability-holders feel that their deposits are fully protected by the federal insuror.

Such blanket insurance creates a problem because it distorts bankers' incentives to take on risk. Decisions about risk-taking in the financial sector generally require an investor to evaluate a trade-off between higher expected profits and greater risk. As a result, the cost of funds is higher for investors engaged in riskier undertakings. For insured banks, however, depositors believe there is no need to evaluate or monitor risk because their deposits are insured *de facto* by the federal insuror. They have no incentive to monitor the risk-taking behavior of their bank, nor do they require a rate of interest that reflects in any way the riskiness of bank assets. When a bank's creditors (depositors) do not share in the losses that arise from default, the bank can borrow funds at a rate independent of the use to which those funds are put. The usual market process—whereby riskier

CURRENT FDIC INSURANCE PRACTICES

A discussion of FSLIC or NCUSIF insurance parallels that of FDIC. To save space, we refer here only to FDIC.

FDIC currently charges each bank a gross annual insurance premium of 1/12 percent (8.3 basis points) of its total deposits, without regard for the bank's financial condition. Legislation requires that, on average, 60 percent of the premium income (after expenses) be rebated to insured banks. Before 1981, FDIC expense levels left the average net cost of insurance at about 4.3 basis points. (The large number of bank failures in 1981 and 1982 raised the effective insurance cost to 7.7 and 7.1 basis points, respectively.) In return for their premium payments, FDIC formally promises to pay a failed bank's depositors up to $100,000 per account (per bank).

Although the FDIC is not obligated to pay off deposit balances above $100,000, historically it has handled most failures in a way that protected all liability-holders (not just depositors up to $100,000) from loss. When an insured bank fails, FDIC has two major options. First, it can "pay out" to depositors 100 percent of their insured funds and leave uninsured liability holders to be paid as general creditors of the bank under the bankruptcy laws. Alternatively, FDIC (in cooperation with the other banking regulators) can arrange a "purchase and assumption" (P&A) in which another bank *purchases* some (or all) of the failed bank assets and *assumes* all of its liabilities. In the course of this transaction, the FDIC frequently exchanges some of the failed bank's weaker assets for cash at book rather than at market value. Creditors acquire a claim on the new bank equal to their previous claim on the failed one. Since its inception, FDIC has handled about half of all insured bank failures by P&A rather than by straight payout. More importantly, the P&A route has been used in failures accounting for the vast majority (94.6 percent) of failed banks' total *deposits.* (Prior to the pay-out of the $517 million Penn Square National Bank's depositors in 1982, the largest bank failure to be handled via payout had deposits of $66.9 million). Less than 1.1 percent of all failed bank liabilities have actually been lost by the public since FDIC began operations in 1934. It appears therefore that FDIC procedures have made the public believe *all* bank *liabilities* are insured *de facto,* even if the *de jure* limit is $100,000 for *deposits* alone.

To limit its exposure, FDIC assesses and controls bank risk by a system of restrictive regulations on permissible financial activities and by periodic on-site examinations intended in part to ascertain compliance with these regulations. Each examination produces a summary rating of the bank's condition, called the CAMEL rating (because it is based on federal examiner assessments of a bank's Capital, Assets, Management, Earnings, and Liquidity) which ranges from "one" (the best condition) to "five" (the worst). Banks with relatively poor CAMEL ratings are subjected to additional supervisory oversight, for example, being required to file frequent, detailed plans for correcting the examiner's perceived problems. In the extreme, FDIC can replace managers and order the bank to curtail certain types of activities.

activities are funded only if they offer a correspondingly higher expected return—thus becomes inoperative. Banks can profit by making riskier investments than they would in the absence of federal deposit insurance: if the more risky assets pay off, the bank owners gain; but if the assets do not pay off and the bank fails, the federal insuror compensates bank creditors for their losses.

In such an environment, bank owners can increase their expected profits by excessively increasing the riskiness, and thus the expected return, of their assets.[1] This increased risk-taking can take many forms. Financing relatively risky projects (a recent example might be energy loans), increasing the maturity mismatch between the bank's assets and liabilities, reducing the asset portfolio's diversification, operating with limited amounts of capital, and aggressively entering new investment areas in which the bank has little expertise are but a few examples of increased risk-taking. This increased risk-taking represents an example of a general implication from economic theory: insurance premia that are unrelated to the risk being insured affect the insured institution's risk-taking

[1]The socially appropriate amount of bank risk-taking would result if the deposit insuror could eliminate bank "runs," while pricing deposit insurance in a way that accurately reflected each bank's probability of failure. For a more detailed discussion of why banks tend to undertake (socially) excessive risks under the current insurance system, see Mark J. Flannery, "Deposit Insurance Creates a Need for Bank Regulation," this *Business Review,* (January-February 1982) pp. 17-27.

incentives. In other words, such insurance premia *distort* private decision-making. Such a distortion of risk-taking incentives affects the economy as a whole, in addition to the obvious implication that there will be a larger number of bank failures. Banks' artificially increased incentive for risk-taking means that some risky projects are funded that would have looked unattractive otherwise. As a result, private financial incentives may induce the economy to undertake more risk than it would in the absence of such a distortion.[2]

The federal deposit insuror has sought to counteract the economic inefficiencies that arise from such distortions with an extensive system of restrictive regulations governing insured institutions. (Similarly, private insurance companies often impose preconditions for insurance, for example, requiring that an insured warehouse include an adequate sprinkler system to limit fire damage.) These regulations are designed, in part, to limit banks' ability to increase their riskiness in response to fixed-premium deposit insurance. As financial market conditions changed, banks discovered new kinds of risk-taking opportunities, and regulators countered with more regulation in an effort to limit banks' ability to take on excessive new risks.

Recent financial market developments raise the question of whether regulations will continue to be sufficient to the task. Banks have entered a new (and growing) set of activities (such as insurance underwriting, brokered CDs, deregulated retail deposit competition, and discount brokerage) that many observers view as riskier than traditional bank operations. Furthermore, a new regulatory environment has allowed financial markets to integrate nationwide, as more states allow statewide banking, and as interstate mergers and acquisitions become part of the rescue process for ailing thrift institutions. These developments have increased competition among financial institutions, which has increased pressures at all levels of government to deregulate the financial system. (The Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Act of 1982 are examples of this deregulation trend.) Given the increases in potential bank risk-taking strategies on the one hand, and the shrinking arsenal of regulations on the other, the federal insuror feels increasingly unable to control its own risk exposure. It is worried that its traditional tools for limiting bank risks are obsolete, and that the current pressures for deregulation may not allow it to impose sufficient new regulations on banks. If new regulations are not imposed, distortions to bank risk-taking will grow, with more bank failures and larger federal insurance payoffs the likely result.

Because of these concerns, the FDIC proposes to change its method of controlling bank risk. Rather than rely exclusively on restrictive regulations, the FDIC proposes to vary its deposit insurance premia in a way that reflects each individual bank's risk of failure (see THE FDIC PROPOSAL). By charging a risk-related insurance premium, the FDIC hopes to move in the direction of restoring the proper incentives for risk-taking by financial institutions. This development would, in turn, reduce the need for regulation. The crucial, and controversial, question is: To what extent could risk-related deposit insurance premia actually substitute for regulation?

SOME DIFFICULTIES WITH A RISK-SENSITIVE PREMIUM SYSTEM

The FDIC's proposed system of risk-related insurance premia is one example of how such a plan might work. Rather than concentrate on one particular plan, we will analyze the general arguments for moving to a fully risk-sensitive deposit insurance premium system.[3] The principal argument in favor

[2] A useful analogy can be drawn with the case of federal flood insurance. Without federally subsidized flood insurance, the cost of living in a flood plain would be higher because each occupant would fully bear her own losses. Cheap insurance against flood damage lowers the expected cost of living in a flood plain, which induces more people to do so. The result is that society suffers an excessive amount of flood damage—more than would be suffered if everyone bore her own losses.

[3] An alternative way to reduce the inefficiencies associated with federal deposit insurance might be privatization of the deposit insurance system. However, we feel that private insurors are not fully credible, and that they would not remove entirely the potential for banking panics. For a more complete, and sanguine, discussion of a private deposit insurance system, see Eugenie D. Short and Gerald P. O'Driscoll, Jr., "Deregulation and Deposit Insurance", Federal Reserve Bank of Dallas *Economic Review* (September 1983), pp. 11-22, or Evelyn F. Carroll and Arthur J. Rolnick, "After Penn Square: The Insurance Dilemma," in *Proceedings* of a Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, 1983.

THE FDIC PROPOSAL

FDIC proposes (in its report "Deposit Insurance in a Changing Environment" (April 1983), pp. II-9 to II-21) a small step toward risk-sensitive deposit insurance premia. Under current law, FDIC may vary the amount of rebate it gives to individual insured banks. In addition to its CAMEL ratings, FDIC proposes to evaluate each bank's exposure to interest rate risk and to credit risk as "normal," "high," or "very high." Only banks judged to have "normal" risk will receive their full insurance premium rebate (60 percent of premium income less expenses). "High" risk banks will receive a 30 percent rebate and, "very high" risk banks will receive no rebate at all. Based on pre-1981 experience, the resulting net insurance costs would then be approximately:

4.3 basis points to normal risk banks,
7.1 basis points to high risk banks,
8.3 basis points to very high risk banks.

Under this scheme, riskier banks will wind up paying higher insurance premia, though some observers doubt whether the range of the variation is sufficiently broad to induce substantial changes in behavior from insured institutions.

To raise a bank's cost of increasing bank risk still further, FDIC will begin charging for its cost of providing extraordinary supervisory services to banks with relatively poor CAMEL ratings. These added costs—coming at a time when the bank is probably experiencing other difficulties as well—is likely to make banks plan more carefully to avoid becoming classified as highly risky.

of risk-sensitive insurance premia is that such premia will bring bankers' assessments of the costs and benefits of risk-taking closer to those that exist in the unregulated financial markets, and that regulation will become largely superfluous as a result. One extreme view of risk-sensitive deposit insurance holds that the federal insuror could remove *all* restrictive bank regulations by using insurance premia that mimic accurately market risk evaluations.[4] But an assessment of the practical difficulties provides convincing evidence that the federal insuror cannot hope to set insurance premia with the degree of accuracy required by this view.

Proponents of risk-sensitive insurance premia prefer economic signals to be transmitted via a pricing mechanism rather than via restrictive regulations. Unfortunately, however, the usual economic argument that a pricing system generally leads to efficient decisions does not apply when a single party unilaterally sets prices (in this case, the insurance premia). In the case of federal deposit insurance, the insuring agency must identify the types of risk banks are exposed to and then determine the premium that it will attach to each risk. This closely resembles the current procedure, which is to identify the relevant banking risks and then devise regulations that limit the banks' exposure to each risk to a socially desirable level. In other words, the insuring agency needs *precisely the same* information to set federal insurance premia as it needs to devise an appropriate set of restrictive regulations under the current premium system. There is nothing to suggest that the information available to bank insurors can be utilized more effectively with a risk-sensitive premium than with the current arrangement (or vice versa). Unless the insurors' premia exactly equal the risk premia uninsured depositors would demand in a perfectly-informed financial market, the federal insurance system will continue to distort private risk-taking decisions (for the same reasons we discuss above). Accordingly, the arguments in favor of risk-sensitive deposit insurance premia suffer several serious shortcomings that must be recognized in the policy debate.

No Single Insuror Can Expect To Assess Risk Perfectly. In the real world, differing evaluations or assessments of risks and returns are common. A banker may lend to an applicant whom another banker has turned down; some investors purchase shares in a certain stock while others get rid of those shares; some analysts predict a rise in in-

[4]See Allen H. Meltzer, "Major Issues in the Regulation of Financial Institutions," *Journal of Political Economy* (August 1967, Part 2), pp. 482-501, or Kenneth E. Scott and Thomas Mayer, "Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform," *Stanford Law Review* (May 1971), pp. 857-902. The FDIC's "Deposit Insurance in a Changing Environment" (April 1983) provides a summary of the recent literature in favor of risk-sensitive premia in its Appendix A.

terest rates while others expect a decline. Just like any other agent in the financial sector, the insuror must anticipate that its insurance premium formula will underprice some risks (in the opinion of the average insured banker) and overprice others. The federal insuror's premia therefore will continue to distort bank investment decisions. Risks considered to be underpriced will expand in bank portfolios while overpriced activities will contract. This result is similar to the current effect of flat risk-premia on bank investments. If imperfect risk-sensitive insurance premia are used instead of restrictive regulations, individual banks, and the banking system, may remain riskier than desired. For example, suppose the insuring agency overprices the risk premium for international loans, but underprices the risk-premium on home mortgage loans. Then international loans may shrink but mortgages will expand relative to their appropriate level. There is no guarantee that the result would be a banking system with less risk than we have currently.

Knowing that it will underprice at least some types of risk, but not knowing which ones, the federal insuror will want to prevent banks from having large exposures to any one type of risk. The most obvious way to avoid large exposure is to promulgate regulations that prohibit "extreme" bank portfolio concentrations. As a practical matter, therefore, risk-sensitive insurance premia probably cannot displace restrictive regulations entirely.

Public Institutions May Have Special Problems. Another crucial difficulty is related to the nature of public institutions such as the FDIC, FSLIC, and NCUSIF. Public institutions' decisions are subject to public scrutiny. Such scrutiny can involve lengthy debates, appeal procedures, and compromises between economic efficiency and political needs. Even the most well-meaning and efficient public institutions move with glacial speed compared to the rapid assessment of information and the continuous reassessment of risk that takes place in the financial markets. Therefore, even if the insuring agency initially manages to assess correctly the risk categories and their risk-premia, it will not be able to keep up with subsequent changes in the market perceptions of those risk categories. Risk premia, then, will tend to reflect past realities. The staff of such public insurors will tend to price yesterday's banking risks, because these risks are at least documentable from past experience, making the pricing less controversial. The staff would be reluctant to assess and project current and future risks, because such projections involve judgements that may be controversial and debatable, and will be regularly challenged in public.

An example that comes readily to mind concerns loans to less developed countries. Given the recent history of such loans, the federal insuror setting risk-sensitive premia would probably set high risk premia for existing and future loans to third world countries, even if the true riskiness of these loans were declining. Furthermore, it would take a long time to reduce these risk premia, even after the true risks decline. Conversely, political pressures would have made it very difficult for the federal insuror to declare loans to countries like Argentina, Brazil and Mexico to be high risk loans before the debt crisis erupted, *even if* the staff had developed strong indications that the riskiness of loans to these countries was on the increase.

Whereas the assessment of risk in efficient markets is forward-looking, the federal insuror's assessment will be mostly backward-looking. Existing risks are bound to become mispriced over time, and it would take a long time to decide whether, and how, to price new risks.[5] This situation will provide still further impetus toward a system of restrictive regulations to supplement the structure of risk-sensitive premia.

ALTERNATIVES TO RISK-SENSITIVE PREMIA

The preceding discussion strongly suggests that risk-sensitive insurance premia will never replace entirely regulatory restrictions on bank activities. Furthermore, there is no assurance that the system of regulation that accompanies risk-sensitive insurance premia will be significantly less intrusive, or even less extensive, than what exists now. We must recognize that risk-sensitive deposit insurance premia represent only a *change in the form* of insuror intrusion on private financial decisions, not an *end* to such intrusions. Restrictive regu-

[5] Furthermore, banks would surely protest risk assessments they considered excessive more vigorously than those they considered too low. The result would be a tendency toward an overall downward bias in risk-sensitive insurance premia, which is similar to what we have today with fixed premia.

lations and risk-sensitive premia can, at best, complement one another in the attempt to control and limit bank risk-taking to a socially appropriate level.

Many of the problems identified so far result from the fact that a single public agency must anticipate the activities of a number of private institutions and respond to them. This fact is independent of whether the agency tries to exert control through prices or through restrictive regulations. The process is administratively costly; it rarely works smoothly or efficiently. One way to supplement the federal insuror's risk assessment would be to increase the risk exposure of bank shareholders and depositors to a limited extent. Investors then would have a stronger incentive to monitor and react to banks' risk exposures, raising the cost of funds to banks that choose to pursue riskier investment strategies.

Increasing Shareholders' Risk Exposure. The distortion associated with the current federal deposit insurance scheme is that shareholders have unbounded potential for gain when they increase their portfolio risk, but they can never lose more than their invested capital. The most obvious way to increase shareholders' concern for bank risk therefore is to raise the proportion of their own capital that must be put into the bank's investments.[6] Because this gives shareholders a larger potential loss if an investment turns sour, they will instruct bank managers to take somewhat less risk. The added bank capital need not necessarily take the form of additional equity. Similar results could be achieved if banks issued more long-term debt subordinated to deposit liabilities. Investors in such debt instruments are (presumably) sophisticated enough to evaluate risk correctly, so the rates banks would pay on this subordinated debt would fully reflect the probability of default. At the same time, the debt's long maturity would reduce the likelihood of destabilizing "runs" if the bank encounters subsequent difficulties.

A second way to increase shareholders' potential losses would be to reform the insuror's procedures for handling troubled banks. History offers several examples of federal aid in the form of subsidized loans or equity contributions to avert bank failures. Eliminating or severely restricting such aid would make shareholders feel less protected from the results of their bank's portfolio risk.

A more drastic way of shifting risk to bank shareholders would involve redefining which bank liabilities the government is willing to insure. The case for federal deposit insurance is strongest for short-term, demand-type deposits that can be withdrawn easily during a crisis of confidence. If the government wishes to insure this kind of deposit (to protect the financial system from runs and other disturbances), it can do so without introducing large distortions. In particular, the insuror could require that insured, demand-type liabilities be issued by a distinct subsidiary of the banking firm, whose permissible investments would be limited to short-term, very high quality securities. Banks could undertake a broad range of investment *outside* their federally-insured affiliates, and investors purchasing those uninsured bank liabilities would know they were subject to default risk. The net effect would be to reduce bank shareholders' ability to borrow via insured deposits at a riskless rate, so their interest cost (and hence their profits) would reflect the riskiness of their investment portfolios.

Increasing Depositors' Risk Exposure. The federal insuror could make large depositors (over $100,000 per account) more sensitive to bank risk by handling more bank failures via straight payout and fewer by "purchase and assumption" (P&A). This change would increase the perceived risk of uninsured liability holders, and it would help bring the average rate banks have to pay on uninsured liabilities in line with the riskiness of the bank portfolio. In other words, under existing law, the insurors could choose to compensate only insured depositors, letting uninsured depositors suffer losses in the event of a bank failure. A straight payout is not without its drawbacks, however, because the failed bank's intangible assets (like accumulated local lending expertise and customer relationships) are destroyed in the process. A P&A has the advantage of preserving these in-

[6] Such a move towards transferring some of the banking system's risk to private individuals (and away from FDIC) was announced in July 1984. The FDIC, the Office of the Comptroller of the Currency, and the Federal Reserve have proposed to set a minimum capital standard for all U.S. banks. This new standard would require "about 700 of the nation's approximately 15,000 commercial banks to raise hundreds of millions of dollars in new capital" (*New York Times*, July 11, 1984).

tangible assets. To make uninsured depositors sensitive to bank risk-taking, therefore, the insurors might modify their P&A procedures to transfer only some fraction of uninsured liabilities to the purchasing institution. An important caveat here is that transferring *too much* risk to depositors can cause the type of bank run federal insurance was designed to prevent.[7]

FDIC already has begun to experiment with this process. For example, it decided to let large depositors suffer some losses in two banks that failed in March 1984: "Regardless of whether other banks were found to take over the two [failed] institutions, depositors with accounts larger than the $100,000 FDIC insurance limit would be treated as general creditors and wouldn't be fully protected" (*Wall Street Journal,* March 21, 1984, page 15). Revising the P&A process in this way would have even greater effects on private risk-monitoring if the statutory insurance limit were lowered from its current $100,000 level.[8] The Banking Act of 1933 initially set an insurance limit of $2,500, which is roughly equivalent to $10,000 in 1983 dollars.[9] With lower insurance limits, depositors would have more incentive to evaluate bank risk and demand appropriate compensation in the form of higher deposit rates from institutions that were deemed to carry the greatest risk of default.

CONCLUSION

Some writers have maintained that risk-sensitive deposit insurance premia can be substituted effectively for financial sector regulation to limit bank risk-taking to an acceptable level. This view, however, fails to recognize that both risk-sensitive premia and restrictive regulations require the insurors to gather and process the *same* amount of information. Furthermore, a public insuror setting risk-sensitive premia will necessarily suffer from the same lags in decision-making that have made restrictive regulations a cumbersome tool in the past. Therefore, there is no reason to believe that the federal insuror can control bank risk-taking any more effectively with risk-sensitive premia than it can currently with restrictive regulations. The potential theoretical advantages of risk-sensitive premia must be weighed carefully against the serious difficulties that arise in practice, and against the benefits of alternative schemes that do not involve risk-sensitive premia.

A partial alternative to public sector controls on bank risk-taking may be to increase the incentive for private sector monitoring. Private sector evaluations are likely to be more timely than those reached in the public domain, regardless of whether the latter are transmitted to insured institutions via premia or regulations. Because of the possibility of bank runs, however, the provision of federal deposit insurance will probably be accompanied by direct federal limitations on private risk-taking. The pending policy issue is *how* that federal intervention can best be effected.

[7] See Douglas Diamond and Philip H. Dybvig, "Bank Runs, Deposit Insurance, and Liquidity," *Journal of Political Economy* (June 1983), pp. 401-419.

[8] In a related development, FDIC and the Federal Home Loan Bank Board (FHLBB) recently have attempted to remove most formal insurance protection from deposits placed in an insured bank by brokers. Over the past few years, a number of brokerage firms have arisen to bring together banks needing funds with depositors outside the banks' customary geographic market area. Previously, a bank might borrow via large ($1 million) certificates of deposits. If these balances were uninsured (at least *de jure*), potential depositors would screen carefully the riskiness of banks to which they lent. Riskier banks could borrow only by paying relatively high deposit rates. By using a CD broker, however, the bank could borrow the same amount (or more) via fully insured $100,000 CDs. Customers with large balances to lend could use brokers to split up their investments into smaller, fully insured components. The FDIC and FHLBB proposed a rule that was supposed to take effect October 1, 1984 to address this problem. Under the rule only $100,000 per broker (per bank) would be insured, giving brokers and their customers a greater incentive to evaluate bank risk. A federal court judge voided this rule in June 1984, saying that the regulatory agencies did not have the authority to impose such a change in insurance coverage.

[9] Very shortly after FDIC began operations, this limit was raised to $5,000.