Could Private Deposit Insurance Stabilize the Banking System?

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Foreword by Joetta Forsyth, PhD, Assistant Professor of Finance …
One of the many joys of teaching at Pepperdine is the chance to hear the many creative ideas that students have about solving business problems as well as problems with our economy. Last trimester I was discussing with my students the topic of how bank deposit insurance provided by the U.S. government actually gives banks the incentive to take on excessive risks. As usual, the discussion was lively and reflective of the remarkable experience and business backgrounds of our undergraduates. I thought I would share with you the thoughts of one of my students. I hope you enjoy his thinking on the subject as much as I did.

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David Caren, BSM
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This past trimester, I had the opportunity to attend Dr. Joetta Forsyth's finance class. Given the financial crisis we are in the midst of, there was no shortage of topics to discuss in class; quite often the discussions would get lively. We often explored ideas for fixing our broken system. One idea brought up was eliminating Federal deposit insurance, which got me thinking.

Dr. Forsyth put forth the idea that we do away with government-insured deposit accounts and let Americans utilize low-risk money market accounts instead. The thinking behind this was that, since the FDIC insures deposits, banks invest those deposits in riskier investments than they should. Without deposit insurance, depositors would demand a higher interest rate on their deposits if the bank invested in risky assets (building in a kind of automatic punishment for taking on risk). However, depositors do not care about bank risk because the deposits are insured by the government, leaving the banks free to invest in risky assets. As evidenced by the recent financial crisis and the resulting slew of bank failures, this seems to be the case.

I did a bit of research and came across this quote from a past president,

> "I can tell you as to guaranteeing bank deposits my own views, and I think those of the old Administration. The general underlying thought behind the use of the word 'guarantee' with respect to bank deposits is that you guarantee bad banks as well as good banks. The minute the Government starts to do that, the Government runs into a probable loss . . . We do not wish to make the United States Government liable for the mistakes and errors of individual banks, and put a premium on unsound banking in the future."

These words were spoken by none other than FDR, right after his inauguration. The very president who signed the Glass-Steagall Act, forming the FDIC, thought guaranteeing bank deposits was a bad idea.

On the surface, government insured deposits seemed like a good idea. At the time FDR signed the FDIC into law, Americans had no confidence in banks. People needed to feel their money was safe. While he did not seem to be a fan of government deposit insurance, he signed Glass-Steagall into law because something had to be done to restore people's confidence. The problem is that government employee compensation schemes don't reward employees for doing a great job nor do they punish those who do a bad job. Those of us in the business world know that compensation drives behavior. Therein lies the problem: while I am sure some government workers go above and beyond out of a sense of duty, government employees are not paid to care. If a bank fails, do the FDIC employees charged with watching over that bank face any sort of repercussions?

Based on the above, Dr. Forsyth made a good argument. By its very existence, the FDIC promotes risky behavior by bankers and is actually doing Americans a disservice. While Americans feel safe that their deposits are insured, they will end up losing some of their money in the form of increased taxes to pay for bank bailouts. I agreed with this part of her argument.

I disagreed with the second part of her argument. In a nutshell, she advocated the elimination of deposit insurance and stated that Americans should start getting used to a little risk. While those of us in the business world tend to understand risk and devote much of our time to managing risk, most Americans don't understand risk and are completely uncomfortable with it. People are willing to settle for much lower returns or, on an inflation-adjusted basis, even lose a little money just to eliminate risk.

This got me thinking. If you agree with the argument that government can't provide an efficient deposit insurance scheme and you buy the argument that most Americans are completely averse to risk when it comes to their money, then what are we to do? We do what we always do when we want to mitigate risk; we go to the private insurance industry. We trust the private insurance industry to insure our most precious assets: our home, our car, even our health and our lives. When viewed in this manner, it is not much of a stretch at all to consider turning to the private sector to insure our money.

In researching this idea, it seems like the idea was kicked around a bit in the midst of the savings and loan crisis in the late '80s. Even before the S&L crisis, the Libertarian CATO institute made the case for private deposit insurance back in 1985. In 1993, Centrex Underwriters, Inc. (amongst others) offered excess deposit insurance that insured deposits in excess of the then $100,000 FDIC limit for about what the FDIC charges banks (.25-.3 percent/year). While demand for this product was short-lived as people regained confidence in the banking system in the boom of the late '90s, we have evidence that private deposit insurance is at least feasible.

In the private sector, people are paid to care. In dealing with the insurance companies, we are all aware (sometimes painfully so) how aggressively they watch over the assets they insure. You can bet they will not let bankers get away with gambling with the deposits they insure. In reaction to the emergence of these private deposit insurance offerings in the early-mid '90s, former FDIC Chairman William M. Isaac said, "The individual depositor will be able to rely on the insurance companies, and the insurance companies will discipline the banks far better than any depositor could."

I could not have said it better myself.

***David Caren** is a 18-year veteran of the information technology industry. He has spent the last 10 years at Cisco Systems educating customers and partners around the country on the business value of Cisco's technology solutions. Drawing on his experience working with a broad array of public and private sector clients, David currently serves at Cisco as a Technical Business Advisor to executives at the "Big 4" consulting firms, working on defining a joint vision for the future of information technology and how it will impact business strategy. David is also currently pursuing his BSM and MBA degree at Pepperdine's Graziadio School of Business and Management.*

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