

DEPOSIT INSURANCE: A HISTORY OF FAILURE

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A deposit insurance system is like a nuclear power plant. If you build it without safety precautions, you know it's going to blow you off the face of the earth. And even if you do, you can't be sure it won't.

—L. William Seidman
Chairman, FDIC

The failures in 1985 of deposit insurance programs in Maryland and Ohio, along with the present difficulties of the Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Deposit Insurance Corporation (FDIC), have sparked a renewed debate over deposit insurance. The extensive problems among insured institutions have led academicians, policy analysts, and even some regulators to reexamine the incentives created by federal deposit insurance. In short, the existence of deposit insurance encourages depositors to choose a bank or savings and loan (S&L) institution without concerning themselves about the business practices of depository managers. This situation frees managers and stockholders to pursue greater profits through assembling portfolios that embody more risk than uninsured depositors would be willing to accept. Because the lost market discipline cannot be fully replaced by government oversight, a federally insured banking system will exhibit more risktaking than one operating without such guarantees. In the insurance industry, this phenomenon is known as "moral hazard."

This article views deposit insurance from a historical perspective and examines the record of state-sponsored deposit insurance. What emerges is a surprisingly consistent pattern: "reckless banking," losses in excess of assessments, increased assessments and borrow-

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ing, and the exit of sound banks from the insurance system, leaving an increasingly risky and ultimately uninsurable pool of remaining banks. In short, the history of deposit insurance has been disastrous. State-sponsored deposit insurance funds have all exhibited the same moral hazard problem that is evident at the federal level today.

The consistent pattern of reckless banking is explained by the perverse incentives of flat-rate deposit insurance. The only real difference between the historical state-sponsored programs and the present federal-sponsored programs is the more universal coverage provided by federal insurance. Federal programs of deposit insurance continue in the face of mounting losses due to reckless banking because sound banks are not free to exit. Thus, federal deposit insurance assessments are effectively subsidies from sound to reckless banks.

If financially sound institutions were free to leave the risk pool, these cross-subsidies would not be possible. The deposit guarantors would then suffer from what insurers call “adverse selection,” in which financially sound banks would exit and an increasingly risky and ultimately uninsurable pool would bring federal deposit insurance to its conclusion.

The “Official” History

The history of deposit insurance includes two waves of experiments: the first during the early 19th century, starting with New York State’s safety fund, and the second during the early 20th century, starting with Oklahoma’s guaranty fund. The FDIC’s annual reports for 1952, 1953, and 1956 recount this history positively. The FDIC (1952, p. 60) states that while a “majority [of deposit insurance programs] eventually proved unworkable . . . several enjoyed a moderate degree of success during their entire operation.”

Specifically regarding the early 19th-century experiments, the FDIC (1953, p. 45) says these programs ceased “when the great majority of state-chartered banks became national banks,” but they were not ended because of “dissatisfaction with the insurance systems.”

Regarding the early 20th-century experiments, the FDIC (1956, p. 47) says, “The systems of the 1908–1930 period were considered highly successful up to the time of the bank failures associated with the depression of 1921.”

Thus, the FDIC—in presenting what may be considered the “official” history of deposit insurance—presents a positive interpretation. This interpretation must be considered suspect, however, in view of the FDIC’s mandate to allay concerns for bank safety.

The Early 19th-Century Experience

The first program of deposit insurance in this country was New York's safety fund, created in 1829 (see Chaddock 1911). The purpose of this fund was to protect the bank notes of and deposits in chartered banks.¹ In the event of a bank failure, the safety fund was to cover losses of depositors and bank note holders from monies collected from insured banks through annual assessments.

The New York safety fund at first appeared successful. However, during the panic of 1837, the New York State legislature found that the safety fund "had scarcely been heard of as a means of upholding credit," and the legislature looked to the Scottish joint-stock banks for a model of bank safety (Knox 1903, pp. 398-415).

In 1842, the fund was exhausted by the failures of 11 insured banks over a three-year period. The state bank examiner identified "reckless banking" as the principal cause of failure in each of the 11 banks, including what would today be described as "insider dealing," as well as a lack of concern for safety by all involved because of the existence of the safety fund.

The City Bank of Buffalo, which was closed down in 1840, was the first of the bank failures. The state bank examiner found a record of large loans to the president and to other officers and directors of the bank, much of the proceeds of which were used to finance speculation in stocks and real estate. Furthermore, as the situation deteriorated, loans and investments of poor quality were substituted for those of good quality, leaving the safety fund with massive losses. In other failures "reckless banking" extended to criminal activity including misrepresentation, diversion of funds, and fraud.

The state legislature responded to these failures by restricting insurance coverage to bank notes and by authorizing borrowing by the safety fund. These borrowings were used to indemnify those who had already suffered losses. This debt proved the undoing of the New York insurance program. Because interest and principal on the debt had priority over new losses, the safety fund had to devote all assessment revenue to debt service for the next 20 years. Accordingly, participating banks and their note holders received little in return for their continuing assessments.

From its peak in 1837 to 1865, the number of banks participating in the New York safety fund fell from 88 (out of a total of 95) banks to only 6 (out of 284). The small number of banks remaining in the

¹Chartered banks were those whose corporate charters were specifically approved by the state legislature. Participation in the safety fund was mandatory for approval or renewal of the charter.

safety fund made their bank notes uninsurable. The fund closed in 1866, at which time it made good on the claims relating to past losses that were presented to it. However, because of the lapse of time since the losses were suffered, the claims that were presented probably constituted only a fraction of the losses that had been incurred.

The more popular form of banking in New York during this era proved to be "free banks." Free banks were so named because they did not require special charters from the state legislature, but could be formed by a relatively simple filing. These banks had their own set of state regulations—such as capital, collateral, and reserve requirements—but were otherwise quite competitive and successful. In particular, free banks did not participate in the safety fund. The growth of New York as a financial center was due to these free banks, and not to the chartered banks and their moribund safety fund.

New York's safety fund was imitated by Vermont in 1831 and by Michigan in 1836. Michigan's safety fund collapsed almost immediately under the strains of the Panic of 1837 with no funds available to cover losses. Vermont's safety fund failed in an experience that closely paralleled that of New York. In Vermont, the number of insured chartered banks fell from 13 (out of a total of 18 banks) during 1841–48 to 0 (out of 41) in 1859. Of the losses suffered under this system, only two-thirds were made good by the safety fund.²

The Early 20th-Century Experience

From 1908 to 1917 eight states passed deposit guaranty legislation. These included Oklahoma, Kansas, Nebraska, Texas, Mississippi, South Dakota, North Dakota, and Washington. All eight guaranty funds failed during the 1920s, starting with Washington's fund in 1921. Of the eight, all but the Texas guaranty fund left depositors with uninsured losses.

Thomas B. Robb, in *The Guaranty of Bank Deposits* (1921), attributes these guaranty funds to granger agitation (see also Cooke 1923). In particular, he describes Oklahoma, which passed the first of the guaranty fund laws, as "the land of sanguine radicalism and experimental legislation," where "a law against it" is the specific for every malady" (Robb 1921, p. 6).

During its first legislative session in 1907, the new state of Oklahoma established a guaranty fund through assessments on state char-

²For a review of the state banks of Indiana, Iowa, and Ohio, see FDIC (1952, 1953, and 1956). These state banks, which were confederations of unit banks (referred to as "branches") were effectively monopoly banks and are considerably different from other banking systems (see Preston 1922, pp. 83–125; and Erickson 1971, pp. 95–116).

tered banks as opposed to federally chartered or national banks), which was to make good the losses of depositors in failed banks.

Almost immediately the fund was in jeopardy as Columbia Bank and Trust Company, the largest in Oklahoma, failed in September 1909. This bank had, in less than one year, expanded its deposits almost eight-fold, from \$365,000 to \$2.8 million, under the protection of the guaranty fund. These funds were, in turn, lent to real estate and oil speculators, including officers of the bank. The person who controlled the Columbia Bank was also involved in other bank failures, including Farmers National Bank of Tulsa that was closed in December 1909 (see Cooke 1911).

The governor took personal charge of the guaranty fund, securing cash by wire for disbursement to small depositors in order to prevent runs on other banks, while making large depositors accept payment in the impaired mortgages of the failed Columbia Bank. This and other failures forced the legislature to impose additional assessments on the remaining banks as well as to authorize borrowing by the guaranty fund.

Initially, the ability to offer insured deposits to the public was attractive to banks, and several national banks rechartered as state banks in order to join the guaranty fund. But as the reality of rising assessments set in, more and more state banks—especially the larger and more financially sound ones—rechartered as national banks.

As a result of this trend, the remaining banks of the guaranty fund constituted an increasingly risky pool, requiring increasingly higher assessments, which increased the incentives for the remaining financially sound banks to leave by rechartering as national banks.

From 1913 to 1923 the number of state banks in Oklahoma dropped from 596 to 443, while the number of national banks increased from 326 to 457. The number of failures among state banks totaled 121, while those of national banks totaled only 10.

Figures 1 through 6 illustrate the effects of the guaranty fund on banking in Oklahoma.³ Figures 1 and 2 show that the guaranty fund initially led to increases in the number of state banks and their deposits relative to national banks. However, after just a few years, and after reckless banking had resulted in several bank failures, the number of state banks and their deposits fell relative to their national counterparts.

Figures 3 and 4 illustrate the effects of the guaranty fund on the liquidity and capitalization of state banks. Figure 3 shows that, prior

³Figures 1–6 are based on data drawn from the Federal Reserve's *All Banking Statistics* (1956).

FIGURE 1
NUMBER OF BANKS IN OKLAHOMA, 1906-15

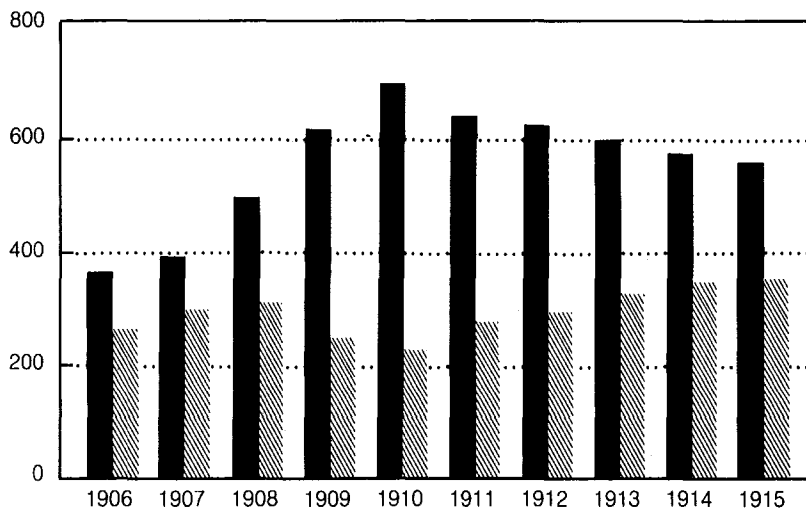


FIGURE 2
BANK DEPOSITS IN OKLAHOMA, 1906-15

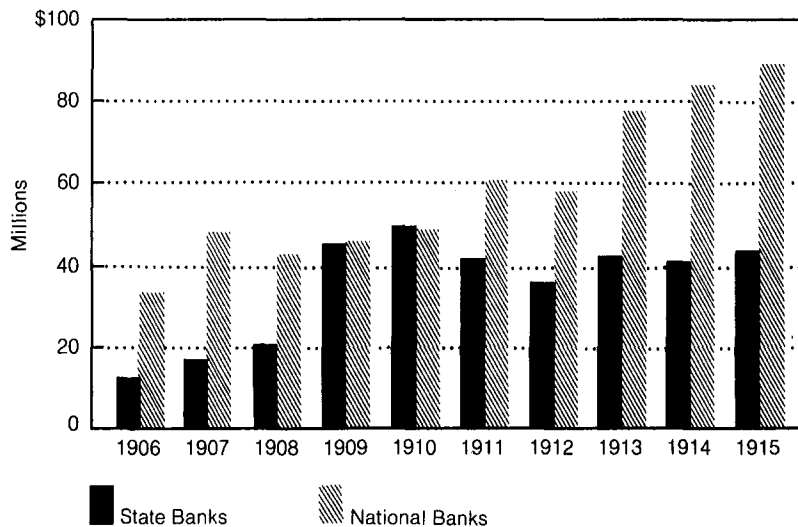


FIGURE 3
LIQUIDITY RATIO IN OKLAHOMA BANKS, 1906-15

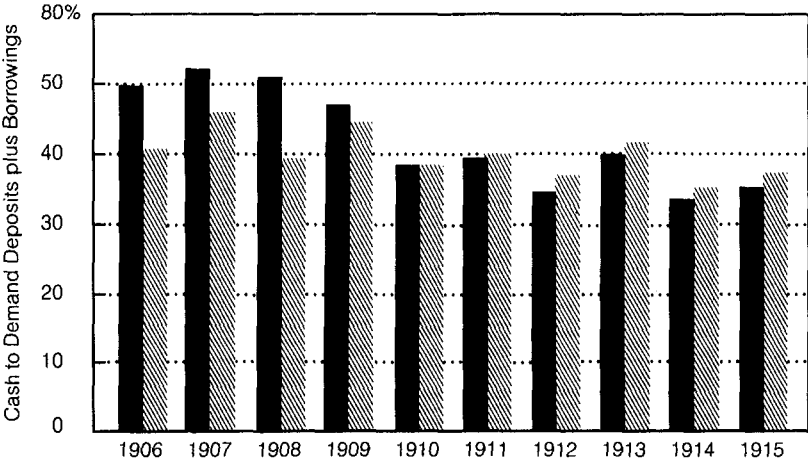


FIGURE 4
CAPITALIZATION RATIO FOR OKLAHOMA BANKS, 1906-15

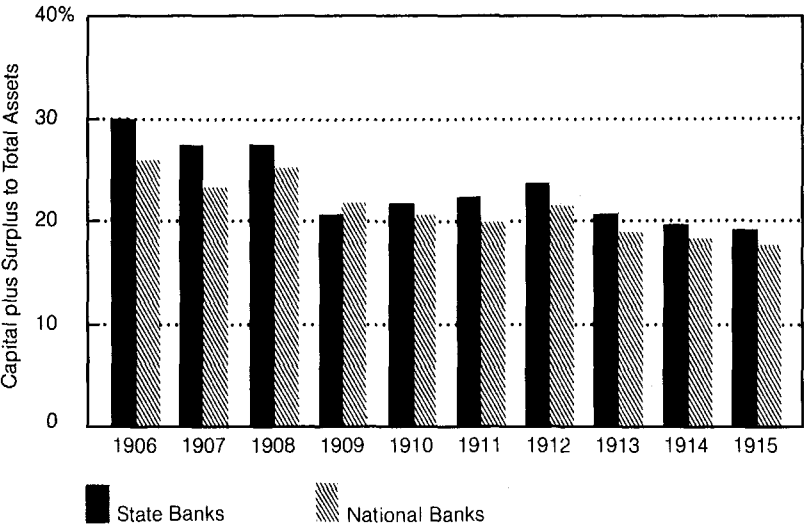


FIGURE 5
RATIO OF REAL ESTATE LOANS TO TOTAL ASSETS IN
OKLAHOMA BANKS, 1906-15

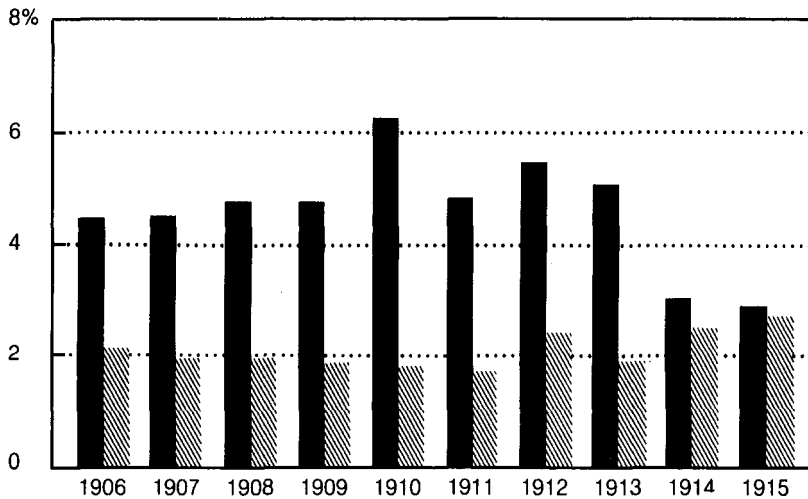
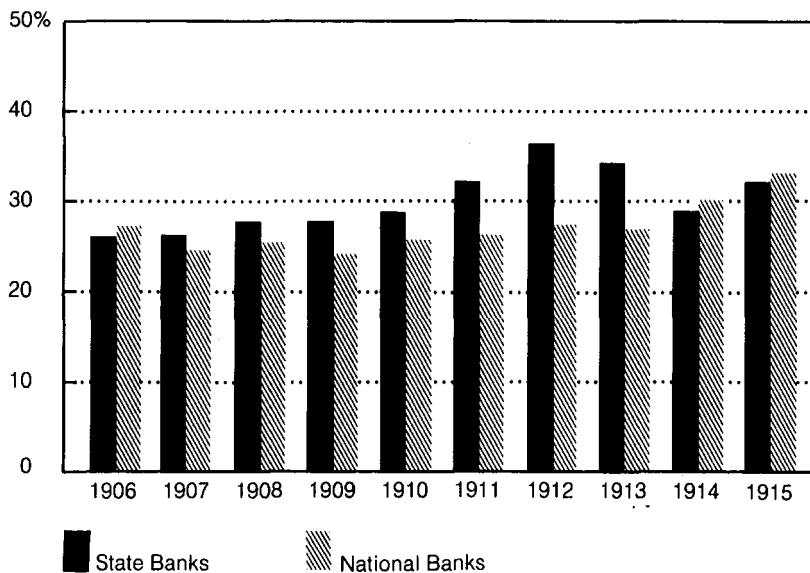


FIGURE 6
RATIO OF COLLATERAL LOANS TO TOTAL ASSETS IN
OKLAHOMA BANKS, 1906-15



SOURCE: *All Bank Statistics* (1956).

to the guaranty fund, state banks had greater liquidity than national banks. This difference is understandable since state banks were generally smaller and probably needed greater liquidity to attract deposits in a competitive market. However, with the guaranty fund and in spite of their smaller size, state banks could operate with less liquidity than national banks. Figure 4 shows that, both before and after the guaranty fund, state banks maintained slightly higher capitalization ratios than national banks. However, in 1909, the first full year of the guaranty fund, state bank capitalization fell relative to national bank capitalization.

Figures 5 and 6 illustrate the effects of the guaranty fund on the risk characteristics of the assets of state banks. Figure 5 shows that, with the guaranty fund, state banks greatly expanded their real estate loan portfolios. Figure 6 shows that state bank lending on collateral experienced a similar although less-marked trend.

Figures 3 through 6 clearly demonstrate that the guaranty fund led state banks to undertake increased risks. These aggregate trends probably understate what was happening on a selected individual bank basis. While the majority of state banks may have continued with business as usual, and thus muted the overall trends, certain banks undoubtedly used the guaranty fund to engage in reckless banking.

While increased risktaking became evident after the first few years of the Oklahoma guaranty fund, by 1923 the fund's situation had become untenable. Interest alone on the outstanding debt of the fund equaled the annual assessment, meaning that the fund had no income or unused borrowing capacity to make good on additional losses. Claiming that "state honor" was at stake, some politicians argued for an increase in assessments or state assumption of the debts of the guaranty fund. However, the legislature simply allowed the fund to go bankrupt, leaving some \$3 million in depositor losses uncovered.

Other States

Washington's guaranty fund collapsed under the failure of the largest bank in its system, the Scandinavian-American Bank of Seattle. Losses associated with this failure consumed the entire fund as well as a special assessment that was levied. Rather than continue to exact high assessments on banks remaining with the fund, the legislature repealed its deposit guaranty law. This action left depositors with 75 cents on the dollar from liquidation of the assets of the Scandinavian-American Bank and only 10 cents from the guaranty fund.

In Texas the guaranty fund was at first viewed quite favorably by bankers. With typical Texan hyperbole, the secretary of the Texas Bankers Association boasted in 1920 that "the guaranty fund was the greatest piece of constructive legislation ever enacted in the country."

In just a few years, with assessments running at the legal maximum in order to cover a growing number of losses, Texas banks left the guaranty fund in droves. From 1924 to 1926, the number of eligible participating banks fell from 896 to 34, and the number of eligible nonparticipating banks increased from 37 to 748. By 1926 the guaranty fund was exhausted. Failures by nine of the small number of remaining participating banks forced the legislature to repeal the deposit guaranty law and liquidate the fund.

In South Dakota, 16 bank failures nearly exhausted the guaranty fund in 1923. Depositors at the seventeenth bank to fail that year were paid half in cash and half in certificates of indebtedness. Even though assessments continued to be levied, losses on subsequent bank failures were covered only by certificates. In 1927, the deposit guaranty law was repealed and the fund liquidated. Liquidation of the fund enabled two payments on the certificates that, combined, amounted to about 1 percent of their face value.

In Kansas, the 1923 failure of the American State Bank of Wichita, the third largest bank in the system, embarrassed a guaranty fund already deep in debt. Interest on the fund's outstanding debt plus interest on the debt expected to be incurred to make good on losses at the American State Bank approximated revenue from assessments, meaning no money would be available to cover future losses. This situation led to a massive exodus of banks from the system and left a remaining risk pool of banks that were uninsurable. When the guaranty law was repealed in 1929, depositors of 88 failed banks were left with nothing.

In Kansas failure rates among banks associated with the guaranty fund exceeded failure rates experienced by nonparticipating banks. From 1919 to 1923, 33 failures occurred among participating state banks, which represented 5 percent of the 691 participating state banks in 1923. In contrast, eight failures occurred among nonparticipating state banks, or 2 percent of the 381 nonparticipating state banks in 1923, and no failures occurred among the 266 national banks.

North Dakota exhausted its guaranty fund in 1920, whereupon it began paying depositors 10 percent in cash from assessments and 90 percent in certificates of deposit. Soon thereafter the guaranty fund ended payments of any kind. By 1929 it became obvious that the fund would never be solvent, and the law was repealed. Depositors at 201 failed banks recovered 10 percent of their deposits, and depos-

itors at another 137 received nothing until 1937, at which time they were paid 1 percent.

In Nebraska the guaranty fund often made good on the losses of depositors by taking over and operating failed banks. Through 1920 this action appeared to protect deposits. However, by that time, losses on state-run banks threatened the solvency of the fund. Accordingly, the fund started to liquidate the banks it was operating and soon ran out of money to pay depositors.

In 1930 the Nebraska deposit guaranty law was repealed, and the past losses of depositors were supposed to be paid through a bond issue and continuing assessments on banks. Voters rejected the bond issue, and the state supreme court rejected continuing assessments as "confiscatory" since no insurance would be provided. This move left depositors at 24 failed banks with only partial recovery and at 164 others with no recovery at all.

For failed banks in Mississippi the guaranty fund issued certificates of indebtedness at an early point to cover the depositors' losses, which were outstripping assessment revenues. As the debt of the guaranty fund piled up, new certificates were no longer marketable. In 1930 the deposit guaranty law was repealed, and the outstanding certificates were paid off by continuing assessments through 1934 and by general tax revenue thereafter.

Analyzing the Data

In its review of the early 20th-century guaranty funds, the FDIC (1956, p. 64) stated: "It is easy to place more stress than is warranted on the presumption that deposit insurance itself led to ill-considered expansion and reckless management." The FDIC did admit that deposit insurance engendered rapid expansions in the number of state banks, as well as in their total deposits and loan portfolios of participating banks, and that inadequate attention was given to loan quality. But other "more fundamental underlying factors" were cited to explain the large number of state bank failures in states with guaranty funds.

Key to the FDIC's argument is that state bank failure rates in some of the states with guaranty funds were lower than in some contiguous states without such funds. The obvious statistical flaw with this argument is the nonrandom selection of test and control states. That is, the FDIC selected only those states with guaranty funds and those contiguous states without guaranty funds whose experience supported its argument.

In order to investigate the validity of the FDIC's claim, we gathered and analyzed the available data on bank failures. When the data are analyzed in a statistically valid way, deposit insurance is found to increase—rather than reduce—bank failures.

Two sources provided the bulk of the data used in our analysis: *All Bank Statistics*, published by the Federal Reserve Board in 1956, which gives detailed information on the number of states and national banks and their balance sheets on an annual basis from 1896 to 1955; and *Banking and Monetary Statistics*, published by the Federal Reserve Board in 1943, which gives complementary information on bank failures from 1921 to 1941. The beginning date of the information on bank failures, 1921, marks the initial year of the analysis. The ending date, 1929, is chosen in order to avoid complications arising from the bank panics of the Great Depression.

The effect of deposit insurance on two measures of bank failure was estimated, while controlling for time, region, and urbanization.⁴ These two measures are the bank failure rate (that is, state bank failures as a percentage of all state banks) and the deposit failure rate (that is, deposits in failing state banks as a percentage of deposits in all state banks).

Other things equal, state banks in states with guaranty funds failed at a higher rate than state banks in states without guaranty funds. Guaranty funds raised the annual failure rate of state banks by 0.7 percentage points. (This estimate is significant at the two-tailed, 10 percent level.) Other things equal, deposits in state banks in states with guaranty funds failed at a higher rate than deposits in state banks in states without guaranty funds. Guaranty funds raised the annual failure rate of deposits in state banks by 1.9 percentage points. (This estimate is significant at the two-tailed, 5 percent level.)

The guaranty funds had a larger effect on the state bank deposit failure rate than on the state bank failure rate. This fact probably indicates that the guaranty funds encouraged unsound growth among selected state banks, which led to their failure.

As a check on the validity of this analysis, the same methodology was applied to national bank failures. Since national banks did not participate in state guaranty funds, the existence or nonexistence of these funds should not have affected national bank failures. On the other hand, if the estimated effects of deposit insurance on state bank failures are due to misspecification (for example, if some other state- or region-specific event accounted for the higher failure rate in states with guaranty funds), then similar results should be obtained in

⁴The full set of results is available on request from the authors.

analysis of national bank failures. In fact, the existence of guaranty funds proved statistically insignificant in explaining analogous measures of national bank failures.

While other "underlying factors" undoubtedly contributed to the high rate of bank failures during the 1920s, careful analysis demonstrates that guaranty funds exacerbated, instead of reduced, the problem.

Current Problems

The pattern of deposit insurance system failures has recently reappeared. In 1983, with the failure of Commonwealth Savings Co., the Nebraska Depository Institutions Guaranty Corporation collapsed. The president of Commonwealth Savings was later sent to prison for criminal activity connected with his bank's failure.

In 1985, in conjunction with the E.S.M. Government Securities scandal in which U.S. Treasury securities were simultaneously sold and used for loan collateral, Home State Savings and Loan failed and took with it the Ohio deposit insurance program.

Also in 1985, insider dealing, diversion of funds, deceptive accounting practices, and other violations of law at Old Court Savings and Loan, as well as growing depositor concerns for the safety of Maryland savings and loans and their insurance program, led to failure of the state's deposit insurance program. Here as in Nebraska the bank president involved was later sent to prison.

These three recent failures of state deposit insurance programs reveal the perverse incentives and lack of concern over risktaking—in short, the "reckless banking"—that characterize flat-rate deposit insurance. Federal deposit insurance programs also exhibit the pattern observed time and again with state programs, although the nearly universal coverage of the federal programs has delayed their failure.

The critical year for the Federal Savings and Loan Insurance Corporation was 1982. In that year, the FSLIC closed 252 thrift institutions, a post-1933 record. However, because of limited cash and personnel, another 201 *insolvent* thrifts were left open. Capital requirements, which are supposed to induce risk-averse behavior and to act as a buffer against unexpected losses, no longer protected the FSLIC. With negative net worth but with continued deposit insurance, the owners and managers of these "zombie" thrifts had a strong incentive to increase their risk exposure. In 1983 and 1984, the FSLIC closed fewer and fewer thrifts, and the number of insolvent but still open "zombie" thrifts rose to over 400 (Brumbaugh and Carron 1987, p. 357).

According to the General Accounting Office (GAO 1986) continuing losses at weak savings and loans threatened the solvency of the FSLIC. Against an estimate of \$24 billion in unrealized losses, the FSLIC had reserves of only about \$6 billion.⁵ Continuing cash flow considerations and even political pressure inhibited the closing of impaired thrifts.

In 1987, the Congress passed a "recapitalization" plan that allowed the FSLIC to borrow up to \$10.8 billion through a shell corporation. Through August 1988, \$8.4 billion of this authority had already been used in reorganizing thrift institutions.

Included among the reorganized thrifts are three Texan high-flyers: Sunbelt Savings Association of Texas, Western Federal Savings and Loan Association, and Independent Savings and Loan Association, whose owners and managers have been removed and barred from the industry and are awaiting criminal investigation for alleged bank fraud and other misdeeds. These savings and loans were notorious for insider lending as well as for making "back-scratching" loan deals among themselves.

A study conducted by the House Government Operations Committee found misconduct in 168 of 210 thrift insolvencies and 98 of 354 bank failures during the three and a half years ending in June 1987. As of June 1988, there were 7,350 bank and thrift cases under investigation by the FBI and federal grand juries ("Misconduct" 1988). Probably the single most outrageous case of reckless banking is that of Vernon Savings and Loan of Texas. When seized by federal authorities in 1987, 96 percent of its \$1.3 billion in loans were in default. Even worse, a delay in the FSLIC's taking over of Vernon caused by the political intervention of House Speaker Jim Wright, allowed the institution to lend an additional \$300 million, all of which appears to be lost.

Estimates of the ultimate cost of thrift reorganizations have been ballooning since the recapitalization was passed. In May 1988, the GAO projected that \$26 to \$36 billion would be required to restore solvency to failing federally insured S&Ls ("GAO Projects" 1988). In Congressional testimony during July, M. Danny Wall, chairman of the Federal Home Loan Bank Board, estimated that \$42.5 billion would be needed by the FSLIC through the next decade to deal with the thrift crisis ("Bank Board" 1988). During August, L. William Seidman, chairman of the FDIC, told Congress that \$50 billion would be required ("FDIC Chief" 1988).

⁵At the end of 1987, the FSLIC's reserves had fallen to negative \$13 billion.

Due to its massive losses, the FSLIC has added special assessments of $\frac{1}{8}$ of 1 percent of deposits to its regular annual insurance premium of $\frac{1}{12}$ of 1 percent. These high assessments are scheduled to continue even under optimistic forecasts of reduced future losses in order to repay the funds borrowed through the recapitalization program. At this time, interest alone on the FSLIC's outstanding debt approximates its total assessment revenue.

Because of the high assessments, some healthy thrifts departed the FSLIC and obtained insurance from the FDIC. Although the actual number of switches was small, applications with the FDIC were increasing. An exodus of healthy thrifts could result in a fund dominated by bad risks. "No insurance system can survive like that," said John Morgan, who is chairman of the National Council of Savings Institutions.⁶ To discourage switching, the FSLIC instituted an exit fee of twice the previous year's assessment, and a temporary ban on withdrawals was included in the 1987 legislation. In 1988, Congress voted to extend this ban.

About one in three thrift institutions have the 6 percent capital-to-assets ratio required to qualify for FDIC membership. Many of these thrifts are likely to opt for the alternative federal deposit insurer upon expiration of the ban on withdrawals from the FSLIC. If sound thrifts start switching, the FSLIC will soon collapse.

Thus, the same historical pattern of perverse incentives leading to losses in excess of assessments, leading to increases in assessments and to borrowing to meet immediate needs, leading to departures of healthy financial institutions and an increasingly risky pool of insureds is becoming evident at the FSLIC. At this time the only break with this pattern is due to the legislative ban on withdrawals.

Once this pattern emerged with state deposit insurance programs, the situation quickly deteriorated to its predictable conclusion. Things are different for two reasons with federal deposit insurance. First, it is more difficult to leave. As a result, flat-rate assessments can be used to a greater extent as a cross-subsidy, and rising premiums can be imposed on prudent financial institutions to protect the depositors of those institutions that take undue risks. Second, federal deposit insurers are backed, at least implicitly, by the U.S. Treasury and the Federal Reserve. These differences have postponed the FSLIC's demise and have allowed it to become a calamity of tremendously large proportion, dwarfing the failures of state deposit insurance programs.

⁶Quoted in "Some Major Thrifts" (1987, p. 6).

Even the FDIC, considered up to now to be financially strong, is showing signs of strain. Bailouts of several large Texas banks during 1988 absorbed much of the FDIC's reserves, perhaps \$5 billion against reserves of \$18 billion at the end of 1987. Remaining reserves could easily be wiped out by bank failures during a recession or a surge in interest rates.

The ability today of federal deposit insurers to increase insurance assessments on sound financial institutions, and so subsidize risk-taking financial institutions, is limited. Money market mutual funds, repo's and eurodollars drain monies out of deposit accounts and, thus, lower potential assessment revenue. At the end of 1987 money market mutual funds, repo's, and eurodollars included in the Federal Reserve's M2 figure totaled \$1.6 trillion. These "unassessable" sources of liquidity were fully 57 percent of the \$2.8 trillion total of demand, savings, and time deposits at banks and thrifts.

Increases in deposit insurance premiums could be expected to shift additional funds to these sources of liquidity lying outside the banking industry. Taking these financial innovations into account, deposit insurance is a particularly regressive tax, falling disproportionately on small and unsophisticated depositors who do not take advantage of these innovations for the benefit of free-wheeling, reckless bankers.

While the Congress could still act to fundamentally reform federal deposit insurance, history demonstrates that legislatures do not act during the "gathering crisis in deposit insurance" to prevent the crisis through reform.⁷ Deposit insurance programs are not reformed; they fail.

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⁷For a discussion of fundamental reform, see Benston and Kaufman (1988). The expression "gathering crisis in deposit insurance" is from Kane (1985).

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