Flawed deposit insurance programs need reform, banking expert says

January 5 2009

Government insurance programs that safeguard bank deposits should be reformed to ease taxpayers' undue stake in propping up the nation's banking system, according to research by a University of Illinois finance professor.

George Pennacchi says the Federal Deposit Insurance Corp., created during the Great Depression to halt bank runs, is supposed to protect savings through premiums paid by banks, but is effectively subsidized by the U.S. Treasury, putting tax dollars at too much risk.

"We have a system where when things get bad, taxpayers end up being forced to pay for bank failures, not just the FDIC," Pennacchi said.

Proof that deposit insurance has grown overly generous has surfaced amid a global economic meltdown, he said, with investment firms such as Goldman Sachs and insurance giant Hartford Financial becoming banks to get access to insured deposits.

"One of the reasons why that's so, and I think this has been a long-standing problem, is that government has tended to subsidize deposit insurance, sort of through a back door," Pennacchi said. "The savings and loan crisis is an example. Instead of premiums paid by thrifts covering the losses, about $124 billion came from taxpayers."

He proposes reforms in a research paper that will be presented this month at an economic conference sponsored by the American Enterprise

Institute, a conservative-leaning, Washington-based think tank that seeks to influence public policy.

One reform, Pennacchi said, is veering away from an approach that provides nearly unlimited government financial backing when large institutions such as Bear Sterns are on the brink of failure. The government, he says, deems some banks "too big to fail," with so many connections to other financial markets that failure could net a disastrous domino effect.

But he says the problem can be addressed without leaving taxpayers on the hook. He proposes a central clearinghouse requiring banks to put up collateral in derivative trading that would cover potential losses if one of the parties fails.

"That would get rid of the too-big-to-fail problem and is done all the time with exchange-traded derivatives," Pennacchi said. "If you trade on the Chicago Mercantile Exchange, there's a clearinghouse that requires both parties to put up collateral, so if one of them fails it doesn't cause a loss for their trading partners."

He says the FDIC should also reform premiums for deposit insurance that have historically been artificially low, covering only average losses and heightening risks of a taxpayer bailout in the event of widespread bank failures.

A move toward rates charged for similar, private-market insurance, such as credit-default swaps, would likely yield significant premium increases, roughly doubling current rates, Pennacchi said.

"But I think that's the minimum that needs to be charged to protect taxpayers and prevent the government safety net from expanding even more," he said.

Pennacchi also advocates either abandoning a dedicated deposit insurance fund, managing the program through the treasury instead, or creating a swap market that would level out banks' premiums.

He says banks could lock in deposit insurance costs through a premium swap market, rather than paying higher premiums when bank failures rise and receiving rebates on premiums when failures are low. The swap market would be similar to interest rate swaps, transferring risk to investors outside of the banking industry.

"If there's any reform that would be easy to do it would be to create this premium swap, which would lead to more stability for banks because they wouldn't face high premiums in bad years when they're least able to pay," Pennacchi said.

His research will appear in a book that will be published this year by the American Enterprise Institute. The book will focus on government guarantee programs ranging from the FDIC to crop and terrorism insurance.

Source: University of Illinois at Urbana-Champaign

Citation: Flawed deposit insurance programs need reform, banking expert says (2009, January 5) retrieved 23 April 2024 from
https://phys.org/news/2009-01-flawed-deposit-reform-banking-expert.html