
Regulatory Moral Hazard

The Real Moral Hazard in Federal Deposit Insurance

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Many banking regulators, academics, and others hold that deposit insurance creates an undesirable moral hazard in banking. But the real moral hazard that federal deposit insurance creates is *regulatory moral hazard*. In this article I describe regulatory moral hazard, explain why depositor discipline of banks is highly undesirable, show how federal deposit insurance fosters regulatory moral hazard and propose a cross-guarantee concept for privatizing banking regulation so as to eliminate regulatory moral hazard in banking.

Moral Hazard

A moral hazard exists when a decision maker takes risks that he otherwise would not have taken, because the adverse consequences of the risk-taking have been transferred to a third party in a manner that is advantageous to the risk-taker and, more important, is disadvantageous and potentially even destructive to the party to whom the risk has been shifted. Insurance is such a risk-transferring device; therefore, the potential for moral hazard exists in any form of insurance, not just in deposit insurance. However, insurance presents a moral hazard only when it is underpriced or the insurance contract lacks sufficient safeguards for the insurer. A properly priced and carefully written insurance contract may actually cause an insured decision maker to take less risk or to be more conscious of the risks being taken than if he were uninsured. This

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desirable result occurs when the insurer assesses and then monitors the insured's risk-taking and sets risk-sensitive premiums designed to deter unwise risk-taking by the insured. Hence, for example, we expect an insured auto driver to drive more safely than an uninsured one: the insured driver fears losing his insurance if he drives carelessly; the uninsured one has no such concern.

Insurance enterprises have operated successfully for centuries, with relatively few failures, because they have used pricing and contractual safeguards to reduce insurance's moral hazard sufficiently to enable insurers to earn the profits needed to attract the capital to support the insurance risks that they have assumed. Deposit insurance has been a notable exception, especially in the United States. Over the last 165 years, most state-run deposit insurance schemes have failed, as did the Federal Savings and Loan Insurance Corporation (FSLIC). However, three successful state deposit-insurance plans operated in Ohio, Indiana, and Iowa prior to the Civil War (Calomiris 1989, 15–19). Those three plans are historical precursors to the cross-guarantee concept discussed in the last section of this article. The relatively few deposit insurance programs in other countries have, in general, not fared much better than those in the United States.

Deposit insurance's moral hazard is rooted in the very rationale of deposit insurance. Quite simply, deposit insurance exists only because bank failures have caused losses to depositors. If banks (used here as shorthand for depository institutions of all types) never failed or, more realistically, if banks failed with no losses to depositors, then no political demand for deposit insurance would arise. Like any other economic good, deposit insurance is demanded only because consumers feel a need for it. The United States has had a richer experience with deposit insurance primarily because it has had so many bank failures, especially in the twentieth century, compared to other industrialized countries.

To identify the root cause of the moral hazard in deposit insurance, we must first explore the underlying causes of bank failures. By definition, a bank fails when, in going out of business, it imposes losses on its creditors, primarily its depositors and, before the Civil War, the holders of its circulating notes (currency issued by state-chartered banks). A bank that liquidates itself or is acquired by another bank without imposing any loss on its creditors is not a failed bank for the purposes of this article, even though it may have been approaching insolvency.

Banks fail for three reasons. First, bad management (poor internal controls, self-dealing, bad lending and investment decisions, excessively rapid expansion, and so forth) is the main cause of isolated or noncontagious bank failures. Second, an economic contagion, almost always triggered by a decline in the market value of assets, causes many banks to fail that in normal economic times would not. Third, government restrictions on asset and geographical risk dispersion limit the ability of individual banks to diversify their asset risk in order to protect themselves against

contagious events such as a regional asset deflation made worse by asset fire sales. In effect, asset and branching restrictions magnify contagion losses by increasing the number of bank failures. Classic examples of such compounding are the enormity of the U.S. banking crisis of the early 1930s, when branching was highly restricted, and the great number of banking failures in the 1980s in Texas and other states that barred or severely restricted branching. The banking problems of the 1980s were further exacerbated by federally tolerated state restrictions on interstate banking and branching.

Prevention of bank failures has been a public-policy concern for as long as governments have chartered banks, because banks, which hold money balances (checkable deposits) and the most liquid savings of individuals and businesses, have been viewed as fiduciaries. The banking function has been a public-policy concern also because banks collectively operate the non-coin-and-currency payments system. Accordingly, politicians have long recognized that it is politically undesirable for depositors and holders of circulating notes to suffer temporary illiquidity and outright losses associated with illiquid or failed banks. Consequently, bank charters almost always have imposed basic safety-and-soundness requirements on bank owners, such as minimum capital requirements, investment and asset restrictions and prohibitions, and liquidity or reserve requirements, intended to ensure sufficient bank liquidity and to prevent bank failures. Government safety-and-soundness requirements are roughly comparable to the “best practices” that would otherwise be specified for banks and other types of fiduciaries. Separately, governments have also used banks to obtain interest-free loans from the public through reserve requirements and government bond collateral requirements for bank-issued currency.

Although safety-and-soundness requirements have always been attached to bank charters, deposit insurance is largely a twentieth-century phenomenon. Governments impose safety-and-soundness or insolvency protection requirements on just a few types of businesses besides banks. Specifically, solvency requirements have been imposed on insurance companies and on securities brokers and dealers for the same reason: to prevent their failure, or at least to ensure that certain classes of creditors, such as those insured by insurance companies, and the customers of securities brokers and dealers, do not suffer losses due to insolvency or fraud. Hence, the sole purpose of bank safety-and-soundness regulation is to ensure that banks do not fail at a loss to their depositors and other general creditors.¹ Some might argue that banking regulation serves only to protect taxpayers against the consequences of failed banks. However, taxpayers are at risk when banks fail only to the extent that they are taxed to

1. In 1993, Congress added a “depositor preference” provision to the Federal Deposit Insurance Act (12 U.S.C. sec. 1821(d)(11)) which gives domestic depositors (insured and uninsured) a higher liquidation priority in a failed bank than other general creditors, including depositors in the failed bank’s foreign branches.

protect depositors in failed banks against loss (witness the savings-and-loan debacle). In fact, banking regulation exists to protect depositors against loss so that taxpayers will not have to protect depositors against loss.

Because it is unrealistic to trust bank owners to comply at all times with safety-and-soundness requirements, governments have enforced these failure-prevention schemes through a bank inspection or examination program complemented by banking supervision. Government banking supervisors intervene, formally or informally, in the management of a bank to prevent its failure. (That branching and asset restrictions increase the likelihood of bank failures, thus compounding the problems that banking regulators must deal with, is a political contradiction that American lawmakers, state and federal, ignored until recent decades.) Therefore, unlike the failure of other businesses, bank failure reflects regulatory failure. There are different kinds of regulatory failure, including restricting branch banking, encouraging institutions to borrow short and lend long (which did in the savings-and-loans), failing to identify problems in banks, sweeping known problems under the rug (“regulatory forbearance”), and others.

It is both reasonable and desirable for depositors and other bank creditors to rely on regulators to prevent bank failures and thereby to protect the creditors from illiquidity and principal losses. Banking regulators act as government-designated agents to prevent bank failures. Creditor reliance on bank regulators is reasonable also because regulators make the rules governing banking activities and then use their legal authority to obtain unique access to private information about every bank, including each bank’s books, records about specific assets, and personnel records (on a real-time basis, if necessary). They can then use this information to assess the condition of every bank that they have chartered. Further, banking supervisors have the legal authority to intervene in a wide variety of ways, such as by issuing a cease-and-desist order to prevent a troubled bank from failing or, if the conditions leading toward failure cannot be reversed in time, by forcing the bank into liquidation or a merger with another bank before it plunges into insolvency.

In other words, banking regulators have both access to information and tools of enforcement that depositors, other bank creditors, and even minority shareholders lack. Only those who actually control a bank are on a par with regulators, and even that is not always the case; an organization that monitors and supervises many banks can be expected to have a better understanding of external threats to bank solvency—such as a looming asset deflation—than many bank managers, who may hold parochial or distorted views of the commercial marketplace in which they operate. Hence, bank regulators are the best positioned of all parties, apart from (or perhaps even including) bank managers, to prevent bank failures that create insolvency losses.

Depositor Discipline Is Highly Undesirable

It is desirable for depositors and other creditors to rely on regulators to prevent bank failures also because this arrangement represents a classic division of labor. That is, a banking regulator, as a government-mandated agent for depositors and other bank creditors, stands in their shoes as a monitor of banks. From a societal perspective, to rely on creditors to prevent bank failures or to second-guess the regulators is less efficient than to demand that regulators perform competently by preventing bank failures. Therefore, relying on “depositor discipline” is less efficient than relying on “regulatory discipline,” because depositor discipline is premised on the notion that if regulators fail to do the job for which they are being paid, depositors should do that job for them. Robert Litan and Jonathan Rauch candidly acknowledge the unreliability of regulatory discipline: “Markets tend to be less forgiving than regulators, who may be more willing to give a troubled institution time to work through its problems” (1997, 118). However, the only practical way depositors can discipline a troubled bank is by withdrawing their deposits. Sleepy regulators, though, will not wake up unless enough depositors run away to create a liquidity crisis at the bank, which in turn creates the potential for contagion and a systemic financial crisis.

One apparent proponent of this logic is Gary Stern (1997), the president of the Federal Reserve Bank of Minneapolis. He argues, in effect, that large depositors in a failed bank should suffer a loss if they are too slow to wake up a sleepy regulator:

Congress [in] 1991 legislation tried to make bailouts less likely by giving regulators new tools to close a troubled bank before large losses develop. *In practice, however, large, complex banks’ financial fires are likely to burn for some time before regulators detect them.* The answer? Uninsured depositors should not receive full protection when a too-big-to-fail bank is rescued. (emphasis added)

A financial crisis, or even the threat of a crisis, wastes real resources. Advocating bank runs to wake up regulators is comparable to urging someone with a malignant brain tumor to operate on himself or to be prepared to intervene in his brain surgery if the surgeon starts to bungle the job. Perhaps a better analogy is the passenger on an airplane. Should passengers, who have no access to the airplane cockpit or the air traffic control system, nonetheless be held even partially responsible if the airplane in which they are riding crashes? The argument for depositor discipline raises this intriguing question: If depositors are fully capable of judging a bank’s condition, why are banking regulators needed at all?

Mistakes will happen, though, and some banks will fail despite being closely regulated, just as even a highly competent surgeon will occasionally lose a patient on the operating table. In most businesses today, malpractice and product-liability

lawsuits as well as product and service warranties (which are insurance by another name) protect consumers from product and service defects. Banking regulation too is a business enterprise, because it provides a service—failure protection—that its customers (banks) pay for through examination fees. Therefore, it is only fair that bank creditors, who ultimately bear the cost of those fees, should be protected against regulatory failure, just as consumers increasingly are compensated, through lawsuits and payments under product warranties, for damages caused by incompetent professionals and defective products. In effect, because regulators are governmentally designated agents for depositors and other bank creditors, they must be liable for their errors, just as surgeons must be liable for their negligence.

Holding the government liable for its regulatory errors is not a completely foreign concept. In 1997 the federal government agreed to pay \$25 million toward settlements that US Airways reached with survivors and victims' families after a 1994 crash because air traffic controllers, who are federal employees, contributed to causing the crash (Bloomberg News 1997). Notice that in this as well as in other airline crashes, no responsibility for the crash was attributed to the plane's passengers or their family members.

Bank regulators, as persons, and the government, as the owner and operator of the bank-regulation enterprise, traditionally have been exempt from malpractice lawsuits because of their "sovereign immunity"—the king can do no wrong. That notion reeks of self-interest. Instead, based on the product-liability analogy, if the government—and by extension the taxpayers—wants to conduct a bank-regulation business, it ought to assume the risks associated with that business, specifically, it ought to be liable to depositors for regulatory error, regardless of the cause or magnitude of the resulting bank failures. Because governments are loath to abandon sovereign immunity, a product warranty, in lieu of lawsuits against the government, is needed to protect depositors against losses in failed banks. Deposit insurance is that product warranty. That is, deposit insurance exists to protect depositors from regulatory error and incompetency, just as product warranties substitute for product-liability lawsuits in protecting, for example, car buyers from manufacturing flaws.²

But deposit insurance is not a free lunch; someone must pay for it. Although general tax revenues could be used to pay for regulatory error, within limits, it is much safer politically for elected officials to tax surviving banks to protect depositors and other bank creditors from regulatory failure. Banks do not generate much political sympathy, even though they pass on to their depositors, in the form of lower interest rates, the deposit insurance tax levied on them. Although called a premium, this levy in fact is a tax when the deposit insurance scheme is a government monopoly in which

2. Although federal deposit insurance was enacted as much to preserve unit banking as to protect small depositors, deposit insurance very effectively protected one form of bad regulation—branching restrictions—that is only now disappearing.

bank participation is mandatory. The FDIC is such a monopoly. Attempting to make FDIC premiums risk sensitive does not alter the fact that they are a tax to the extent that they are not truly risk sensitive—and in fact they are not.

Federal Deposit Insurance Fosters Regulatory Moral Hazard

Federal deposit insurance fosters regulatory moral hazard, or regulatory slackness, because the deposit insurance tax shifts the cost of regulatory error from depositors and taxpayers to the nation's surviving banks, which politically are less able than depositors and taxpayers to avoid paying the losses arising from bank failures. Consequently, because of the relatively small pain that the deposit insurance tax causes banks, up to a certain point regulators can afford to be less diligent than they would be if depositors or taxpayers in general paid for bank-insolvency losses. In this circumstance and in the absence of a banking crisis, regulatory diligence declines. In effect, it is the relative political ease of taxing surviving banks to cover bank-insolvency losses that arise from regulatory error that creates regulatory moral hazard.

Banks generally do not resist bearing the costs of regulatory failures that are imposed on them—in the form of both deposit insurance premiums and costly regulatory safeguards—if the risk-spreading benefits of deposit insurance, specifically the ability to operate with higher leverage (Ely 1997), significantly exceed the cost of regulatory failures. However, regulatory moral hazard consumes much of the benefit that deposit insurance, as insurance, conveys to banks, as evidenced by the banks' substantial loss of market share, in terms of assets held on-balance-sheet, to less regulated financial intermediaries such as mutual funds. By one estimate, banking's market share has dropped by half since the end of World War II (Kroszner 1999, 3). Mispriced deposit insurance and one-size-must-fit-all regulation increasingly create a substantial cross subsidy that flows from well-run to badly run banks. This cross subsidy arises because well-run banks are overcharged for their deposit insurance and, worse, are subject to excessive safety-and-soundness requirements, whereas badly run banks are undercharged for their deposit insurance and may be subject to insufficient safety-and-soundness requirements (Ely 1999a, 13–15). Even less onerous regulatory treatment for “well-capitalized” banks does not overcome the crudeness of one-size-must-fit-all government regulation and risk-*insensitive* pricing of deposit insurance.

The increased regulatory laxity fostered or subsidized by the deposit insurance tax represents the true moral hazard of deposit insurance. Worse, the federal deposit-insurance tax subsidizes regulatory laxity in all its forms: the incompetency and lack of accountability of regulatory officials; branching restrictions; and unwise but government-encouraged policies such as borrow short, lend long and the excessively risky lending prompted by the Community Reinvestment Act. Understandably, then, rational regulators would oppose any effort to increase depositor discipline on banks,

because the inevitable losses suffered by depositors who do not run fast enough from failing banks will create political pain for elected officials. Rational bankers also would oppose depositor discipline because the failure-protection safeguards that politicians will impose on banks that are explicitly subject to depositor discipline will be much more costly than the safeguards needed in a sound deposit insurance program.

Regulatory laxity can become excessive, though, as it did in the years leading up to the savings-and-loan crisis and as it almost did prior to the commercial banking problems of the late 1980s and early 1990s. Excessive laxity creates a situation in which the surviving institutions simply cannot pay, or can successfully resist paying, for the entire cost of regulatory failure. At that point the general taxpayers are tapped, usually by mortgaging future tax collections through government bond sales that raise sufficient cash to protect depositors and other creditors of failed banks. The funding of the U.S. savings-and-loan cleanup, the French government's multibillion-dollar bailout of Credit Lyonnais, and the bank bailout costs now hitting taxpayers in Japan and other Asian countries are excellent examples of the tax consequences of excessive regulatory laxity.

Regulatory moral hazard is costly even in benign economic times, and almost certainly its cost will rise in future years, for three reasons. First, there is the cost of the occasional bank failure. Second, and much more significant when few banks are failing (as at present in the United States), are regulatory compliance costs, specifically safety-and-soundness requirements, that politicians impose on banks to prevent excessive regulatory laxity. Third, the costs associated with regulations designed to curb regulatory laxity prompt creative people to engage in regulatory arbitrage by constructing lightly regulated channels of financial intermediation, such as money-market mutual funds, asset securitization, and hedge funds, that seemingly pose no risk of loss to creditors or taxpayers. The near collapse of Long Term Capital Management (LTCM) in the late summer of 1998 is an excellent example of regulatory arbitrage gone sour. In effect, regulatory arbitrage finds it profitable to expend real resources to lawfully sidestep efficiency-impairing regulations. The growth of regulatory arbitrage may be a key reason why the financial sector of the U.S. economy has doubled its percentage share of the GDP over the last 50 years.

Electronic technology is raising the cost of containing regulatory moral hazard by destroying the efficacy of traditional banking regulation. New technology is making government's one-size-must-fit-all regulation increasingly unworkable, and therefore inefficient, as it facilitates regulatory arbitrage. Elected officials respond to this arbitrage by imposing additional costly regulatory burdens on the parties they can still ensnare in their regulatory net.

Numerous banking observers have implicitly, if not explicitly, recognized the problem of regulatory failure, but they have dealt with the problem by developing devices for sidestepping rather than eliminating it. They seek to fix the old jalopy rather than buy a new car. For example, Edward Kane (1997) has observed that

“regulators around the world energetically resist accountability,” and he has considered “what kinds of regulatory schemes and truth-telling requirements might be used to improve accountability for regulatory performance” (147). Matthew Billett, Jon Garfinkel, and Edward O’Neal (1998) have observed that “the current regulatory structure may undermine the effectiveness of market discipline in deterring bank risk-taking. Moreover, the effectiveness of market discipline declines as a bank becomes more risky because riskier banks use more [government] insured deposits” (355). Many other commentators on banking regulation acknowledge at least by implication the inherent shortcomings of government banking regulation.

Proposals to remedy regulatory shortcomings generally reflect one of two approaches: reduce the riskiness of banks or increase the market discipline over banks to compensate for ineffective government regulation. The first approach often includes the “narrow bank” proposal for limiting a bank’s assets to government debt or high-quality, short-term commercial paper. Litan (1987) presents the classic prescription for a narrow bank. However, the narrow-bank scheme merely shifts the potential for systemic instability, and the taxpayer bailout it may necessitate, to nonbank financial firms, as the LTCM fiasco demonstrated.

Requiring banks to sell more subordinated debt is another nostrum that has been offered to compensate for the shortcomings, or worse, of government regulators. Under this proposal the financial marketplace would signal to the regulators that a bank was weak if the yield on the bank’s subordinated debt amounted to more than a specified percentage above the yield on U.S. Treasury debt of a comparable maturity, or if the bank could not keep enough subordinated debt outstanding because the markets refused to buy the debt at any price or kept “putting” it back to the bank, that is, seeking repayment at will. Joseph Haubrich (1998), an advocate of puttable subordinated debt, observes that some proposals, presumably including his own, “take important actions out of the regulators’ hands. . . . The puttable debt drags the bank (and the regulators) into the public eye and thus increases accountability”(63). Charles Calomiris (1999), a vigorous advocate of subordinate debt discipline for regulators, recently observed that “government supervision and regulation, without any external market-derived pressure, are bound to fail” (34). But that statement begs the question, Why have government banking regulation in the first place?

Eliminating Regulatory Moral Hazard

Any attempt to eliminate regulatory moral hazard must first recognize that raising the standard of living is a major public-policy goal in the United States and most other countries. A key to boosting living standards is eliminating public policies that impose inefficiencies on business enterprises, including banks. Permitting the commercial marketplace to minimize moral hazards is one way to improve business efficiency. Essential to minimizing moral hazard is ensuring that the decision maker who causes a

moral hazard will bear the full cost of whatever hazards that decision maker has created. This notion, inherent in any form of privately provided insurance, can be applied to banking and deposit insurance.

Because banking regulation today is universally a government monopoly, only the political marketplace can limit the cost of regulatory failures. In effect, banking regulators do not benefit from the competitive pressures of the commercial marketplace that would force them to operate efficiently and to properly price their product, which is loss prevention. Proper pricing of a product, especially insurance, is essential for optimizing its usage.

Properly priced deposit insurance, that is, risk-sensitive premiums based on *leading* indicators of banking risk,³ would eliminate the moral hazard commonly associated with deposit insurance because risk-sensitive premiums would induce banks to become better risk-takers, which in turn would optimize bank risk-taking for the entire economy. Properly priced deposit insurance would minimize regulatory moral hazard and the cross subsidy that it produces within the banking industry. However, a government monopoly can never properly price deposit insurance, because accurate pricing occurs only in private, competitive markets. Competing private regulators would not be able to get away with regulatory laxity, because well-run banks would seek to be regulated by more efficient regulators who charged premiums and imposed safety-and-soundness requirements that did *not* subsidize badly run banks. In effect, regulatory moral hazard exists today because federal deposit insurance and the regulations that accompany it are not subject to the forces of the commercial marketplace.

Proper pricing would also make a bank more sensitive to its own risk-taking than it would be if it operated without deposit insurance, because deposit insurance pricing, as opposed to changes in the bank's stock price, can reflect a bank's risk-taking more accurately and in a more timely manner. The highly leveraged nature of banking, which deposit insurance enhances, makes banks even more sensitive to their risk-taking. As with any other product or service, though, insurance (of any kind) can be properly priced only in a private, competitive marketplace. Hence, elimination of the regulatory moral hazard in deposit insurance requires that the business of banking regulation be privatized so that both bank regulation and deposit insurance can benefit from the forces of competition. The political marketplace ought to delegate to a properly structured commercial marketplace the responsibility for ensuring the sound operation of individual banks. Like many other activities, *ensuring the safe and sound operation of individual banks has become too important to the overall health of the economy to be left to government.*

3. Leading indicators of risk specific to a bank include internal control deficiencies, risk mismatches, and excessively heavy asset concentrations. The key external leading indicator of banking risk is a bank's credit exposure to an asset bubble.

The Cross-Guarantee Concept for Privatizing Banking Regulation

The “cross-guarantee” scheme (Petri and Ely 1995) represents one way, perhaps the only way, to successfully privatize banking regulation and deposit insurance. In a world of cross-guarantees, instead of being subject to government safety-and-soundness regulation and supervision, banks would contract for such regulation and its attendant product warranty. In effect, the cross-guarantee plan substitutes negotiated contractual regulation for one-size-must-fit-all government regulation. Contractual regulation is *not* deregulation or self-regulation. Instead, it represents a shift of the regulatory function from the government to the private sector by means of contracts tailored through negotiations to the circumstances of individual banks.

Specifically, each bank would negotiate with an ad hoc syndicate of voluntary guarantors (largely other banks) the prudent banking practices that the bank agrees to follow. The guarantors would select one of several competing private firms, called syndicate agents, to monitor the bank’s compliance with the terms of its cross-guarantee contract; in effect, syndicate agents would replace government bank examiners and supervisors. The contract would also guarantee all deposits and almost all other liabilities of the bank against loss should the bank become insolvent. That guarantee would effectively serve as the contract’s product warranty, thereby meeting the public-policy objective that banking regulation protect depositors and other bank creditors against bank insolvency losses. That protection would also produce another highly desired public good: a stable financial system (Ely 1999b). The guaranteed bank would pay a negotiated, risk-sensitive premium to its guarantors for providing their guarantee. A portion of the premium would be paid to the syndicate agent as a contract monitoring fee; the balance would compensate guarantors for the insolvency risk they assume on behalf of the bank’s depositors and other guaranteed creditors.

The cross-guarantee concept has been incorporated into a comprehensive legislative proposal. H.R. 4318, a bill introduced by Representative Tom Petri in the U.S. House of Representatives on September 28, 1996, would utilize marketplace competition in three ways to improve the efficiency of banking regulation while minimizing moral hazard:

- Negotiating the prudent banking practices to which it will adhere would permit a bank to tailor those practices to its business strategy, but in a manner that minimizes its guarantors’ risks. Today, one-size-must-fit-all banking regulation forces banks to follow herd-like and therefore suboptimal business strategies that periodically cause financial crises.
- Banks and their guarantors would negotiate premium-pricing formulas based on *leading* indicators of banking risk. The FDIC’s risk-sensitive premiums are, for

political reasons, based on lagging measures of banking risk. This political reality was dramatically illustrated in early 1999, when the FDIC announced that it intended to raise the deposit insurance premium rate for well-capitalized banks with so-so managements (Barancik 1999a). Because of negative political reaction, the FDIC quickly backed away from that proposal (Barancik 1999b). In effect, cross-guarantee premiums would encourage a bank to incorporate in the interest rates that it charges the impact a particular risk is expected to have on its cross-guarantee premium. More accurate pricing of bank credit would lead in turn to more efficient use of that credit, which is highly desirable from a societal perspective.

- Because syndicate agents would compete for business on a contract-by-contract basis, they would have to monitor banking risks efficiently without alienating the banks they monitored or causing significant losses for guarantors. The competitive pressure on syndicate agents would be so severe that a major preventable loss to the guarantors of a failed bank could cause its syndicate agent to be fired as the monitor of other cross-guarantee contracts; a Barings- or Daiwa-type monitoring failure might even drive the syndicate agent for the failed bank out of business. One of the many failings of government banking regulation is that the regulators rarely suffer personally for insolvency losses among their charges.

In sum, the cross-guarantee proposal allows numerous constructive marketplace tensions to foster better banking regulation.

Further, the federal government would ensure that each cross-guarantee contract complied with explicit risk-dispersion rules designed solely to ensure that all losses incurred by guarantors in protecting the creditors of failed institutions remain entirely within the universe of guarantors, even in economic conditions far worse than the Great Depression. Preventing the failure of individual institutions would be the exclusive responsibility of guarantors and their syndicate agents. There are four risk-dispersion rules: (1) every guarantor must be guaranteed by a syndicate of other guarantors, thereby creating an interlocking web of guarantors; (2) each contract must have a minimum number of guarantors, no one of which can assume more than a specified amount of risk under the contract; (3) individual guarantors must be limited in the amount of risk they can assume under any one contract and in the aggregate; and (4) all guarantors must be subject to a uniform stop-loss rule that will spread all of a guarantor's losses beyond a certain level to its own guarantors and, if necessary, to additional levels of guarantors.⁴

4. Numerous articles and papers about cross-guarantees, as well as the Petri legislation, have been posted at <http://www.ely-co.com>.

Conclusion

Improvements in electronic technology increasingly reveal the inherent weaknesses of government banking regulation. The political marketplace has responded with even heavier regulation of those it can most easily regulate, specifically banks, while developing mechanisms that ensure, as a practical matter, that surviving banks and not the general taxpayer will pay for future deposit insurance losses. But this regulatory product warranty has become increasingly expensive for banks, thereby distorting the financial intermediation process by increasing the incentives for regulatory arbitrage. In effect, federal deposit insurance has augmented the societal cost of regulatory moral hazard. Only through the use of market mechanisms can regulatory moral hazard be eliminated. The cross-guarantee proposal represents one way, perhaps the only way, to apply market processes to eliminating regulatory moral hazard—the real moral hazard in federal deposit insurance.

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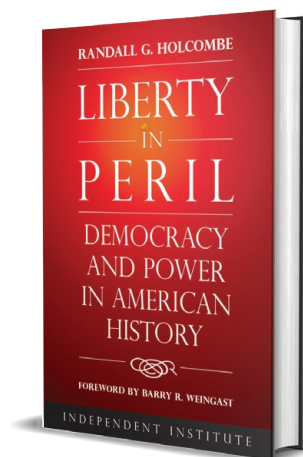
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