In the final days of 1988, negotiators at the Federal Savings and Loan Insurance Corporation found themselves working nights and weekends to complete deals that would turn ailing thrifts over to new owners. By the end of the year they had placed, by General Accounting Office estimates, roughly $90 billion in thrift assets in new hands, at a loss to the FSLIC of $38.6 billion. And they were being criticized widely for their slowness in closing insolvent thrifts, many of which had been allowed to pile up massive losses through fraud and mismanagement.

The FSLIC could ill afford more losses. Despite a rise in premium collections and a special recapitalization loan arranged by a 1987 Act of Congress, the insurance program was already $75 billion in the red at the end of 1988, according to the GAO. In the end, the FSLIC disappeared into a new entity, the Savings Association Insurance Fund, with the special act of Congress that was required to mend the safety

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net for thrift depositors. The cost of that legis-
lation, the Financial Institutions Reform, Re-
cover, and Enforcement Act of 1989 (FIR-
REA), has been estimated by the Administra-
tion at no less than $166 billion. The cost
represents some 20 percent of the insured sav-
ings deposits the FSLIC was established to
protect.

Has enough been done to prevent further
costs on this scale? To find out, the Treasury
Department is coordinating a FIRREA-mand-
dated study of the deposit-insurance system.
The need for such a study underscores con-
tinuing concern about the system's fundamen-
tal design. Past studies suggest that one area
deserving more scrutiny is bank closure by
regulators. Currently, deposit insurance sub-
didizes risky and insolvent banks and thrifts,
sharply reducing their private incentive to close
or reorganize themselves. The system can be
protected only by reducing the subsidy and
improving regulatory closure.

The Search for the Best Closure Policy.
Regulatory bank closure has two intertwined
objectives. One is to protect the deposit-insur-
ance fund and keep down the cost of deposit
insurance. The other is to promote the effi-
ciency of banking. Taken to its extreme, the
first objective—protecting the deposit-insur-
ance fund—can be met completely, and re-
quire relatively little information, if regulators
always close any bank that nears insolvency.
However, a brush with insolvency may be due
merely to bad luck, and an unlucky efficient
bank may find itself closed along with the
inefficient bank. Ideally, regulators should be
able to sort through the banks that come close
to insolvency and keep open those banks that
are well-managed and efficient. But to differ-
entiate between efficient and inefficient banks,
regulators need a great deal of information,
some of it difficult to obtain.

Two key steps are necessary to improve
closure policies: 1) reduce the subsidy to ineffi-
cient banks and thrifts so they are less likely
to merge or close themselves without regulatory
interference; and 2) improve the information
available to bank regulators so that they can act
in a timely, discerning manner.

This article is intended as a primer on the
issues surrounding efficient closure of insured
banks and thrift institutions. The closure
policies fall into three categories: efficient clo-
sure, general forbearance, and quick closure.
Efficient closure aims to close inefficient banks
that jeopardize the deposit-insurance fund.
General forbearance gives banks as much time
as possible to return to health. And quick
closure seeks solely to protect the insurance
fund.

DEPOSIT INSURANCE CAN ENCOURAGE
INEFFICIENT BANKING

Before the institution of deposit insurance,
depositors frequently enforced a policy of quick

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1 For a discussion of the FIRREA, see Richard W. Lang
and Timothy G. Schiller, "The New Thrift Act: Mending the
Safety Net," this Business Review (November/December
1989).

2 See George J. Bebosten and others, Perspectives on Safe and

FEDERAL RESERVE BANK OF PHILADELPHIA
closure by withdrawing their deposits en masse in a bank run. However, depositors often were not able to distinguish sound banks from unsound banks, and runs could force both solvent and insolvent institutions to close their doors. By guaranteeing deposits, deposit insurance prevents bank runs.

The troubling aspect of deposit insurance is that it can encourage failing institutions to continue operating unless they are closed by regulators. An insolvent bank or thrift can continue to attract funds because the deposits are guaranteed by the insurance fund and the depositors feel protected. Thus, losses do not necessarily lead depositors to force an insured bank out of business, as would happen in the absence of deposit insurance.

On the other hand, the bank or thrift will not close itself, since to do so would leave its shareholders empty-handed. The shareholders will opt to keep the bank in business, hoping that a lucky investment or a change in the environment allows a return to profitability. Worse yet, dishonest bank managers may make loans to themselves or associates, gaining favorably priced loans at the expense of the dying institution and the deposit-insurance fund.

**Inefficient Banks Have an Incentive to Stay Open.** The current flat-rate premiums for deposit insurance give an inefficient, risky bank—whether insolvent or nearly so—a strong incentive to stay in business. All insured banks pay the same premiums, as do all insured thrifts: banks pay $1.20 per $1,000 of deposits, and thrifts pay $2.08 per $1,000 of deposits. In exchange, the insured financial institution is able to guarantee that deposits (up to the statutory limit of $100,000 per account) will be repaid, even if the financial institution proves insolvent.

If the true riskiness of deposits is greater than its payments for insurance and any premium necessary to attract deposits, then the financial institution is effectively being subsidized by the deposit insurer. And a subsidized institution has an incentive to stay in business even if it is inefficient.

**Origins of the Thrift Problem**

The mortgage rate was around 9 percent from 1974 to 1977. It increased to 9.6 percent in 1978, then leapt each year thereafter, finally reaching 16.4 percent in November 1981. All rates went up, including the interest rates savings banks paid to depositors. As a consequence, the thrift industry as a whole lost money: the mortgages that had been made in the 1970s were not earning enough to cover the cost of funds in the early 1980s (see Historical Data on the FSLIC, p. 18).

There is now widespread agreement that thrift regulators, during the 1980s, permitted too many thrifts to stay open for too long. This policy of forbearance was, in fact, sanctioned by the Federal Home Loan Bank Board and by legislation such as the Garn-St. Germain Depository Institutions Act of 1982. During the early 1980s, thrifts were permitted to abandon generally accepted accounting principles in favor of a far less stringent set of accounting rules, dubbed regulatory accounting practices. As a consequence, hundreds of insolvent thrifts were able to keep their doors open.

Closing thrifts during the deep recession of the early 1980s would have been extremely difficult and expensive. At that time, almost all thrifts were losing money, and there would have been few potential merger partners. With the end of the recession in 1982, and the rapid decline in interest rates that followed, many thrifts were able to return to health. By 1986, however, interest rates were down to about 10 percent, and housing activity had rebounded. But instead of accelerating closure, the FSLIC began to unwind its assets at a rate much faster than expected. This led to a significant increase in the number of failures, and the FSLIC was forced to take over more institutions.

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4Beginning in 1991, banks will pay $1.50 and thrifts will pay $2.30 per $1,000 of deposits. Thrift premiums will decline to $1.80 in 1993 and to $1.50 in 1998, at which point thrifts will again be paying the same amount as banks.
### Historical Data on the FSLIC

<table>
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<th>Year</th>
<th>Mortgage Rate&lt;sup&gt;a&lt;/sup&gt; (% per year)</th>
<th>FSLIC Reserves&lt;sup&gt;b&lt;/sup&gt; (billion $)</th>
<th>S&amp;L Income&lt;sup&gt;c&lt;/sup&gt; (billion $)</th>
<th>S&amp;Ls In Operation&lt;sup&gt;d&lt;/sup&gt; (thousands)</th>
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<sup>a</sup> Conventional loans on new homes, effective interest rate in percent, annual average, Federal Home Loan Bank Board (FHLBB).

<sup>b</sup> Total FSLIC reserves, year-end, FHLBB.

<sup>c</sup> Net income after taxes, FSLIC-insured savings institutions (includes FSLIC-insured savings banks), FHLBB.

<sup>d</sup> Number of FSLIC-insured savings institutions (includes FSLIC-insured savings banks), year-end, FHLBB.

Data for the above series through 1988 are available in convenient form in the Strings Institutions Sourcebook 1989, United States League of Savings Institutions.


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found itself with insufficient funds to close thrifts rapidly, and it permitted more and more insolvent thrifts to remain open.

A New Attitude Apparently Prevalts. Now the pendulum appears to be swinging in the opposite direction; it is now being proposed that thrifts and banks, even though solvent, be closed if their net worth—which provides a cushion against deposit-insurance losses—falls too low. For example, five academic experts on banking have called for closing depository institutions "when the market value of net worth goes below some low but positive percentage, such as 1 or 2 percent of assets." But is the pendulum swinging too far? If that principle had been in place in 1981, virtually the entire savings and loan industry would have been closed. And

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<sup>c</sup>This proposal is in Benston and others (1986), p. 309.
with few available buyers, the losses would have been enormous.

Clearly, today’s first order of business is to return thrift regulators toward a standard of efficient closure, which is an important element of the FIRREA. But this closure of insolvent thrifts needs to be buttressed by more efficient decisions on closure, providing regulators with more information to help them separate the sound and unsound institutions. Though forbearance created severe problems, speeding closure alone is not a sufficient response. Improving the efficiency of closure decisions also requires increasing both the quality and quantity of the information brought to bear by regulators and other parties.6

HOW BANKS ARE CLOSED

How are banks actually closed? At present, bank regulators first make a preliminary identification of problem banks using the quarterly Reports of Condition and the quarterly Reports of Income required of all insured banks. Banks earmarked by these “early warning systems” are then investigated further. Bank regulators identify problem banks using a system nicknamed CAMEL, which rates banks on capital, asset quality, management, earnings, and liquidity.6 Banks classified as problem banks are then told to correct deficiencies, first voluntarily and then, if necessary, through cease-and-desist orders.

Under current law, banks and thrifts can be closed only if they are deemed insolvent by the bank- or thrift-chartering regulator—the state regulator, the Comptroller of the Currency, or the Office of Thrift Supervision. Thus, the accounting rules that define solvency are an additional, and crucial, issue.

What Makes an Institution Insolvent? Any institution is insolvent when an accounting of its assets and liabilities reveals that liabilities exceed assets. Unfortunately, the proper method for accounting for assets and liabilities is not straightforward.

Suppose a thrift makes a mortgage for $100,000 at a fixed interest rate of 8 percent. The mortgage is entered into the thrift’s books as an asset of $100,000 and initially earns $8,000 a year in interest. But suppose that after the loan is made, interest rates skyrocket and the fixed rate for mortgages rises to 16 percent. If the thrift were to make the mortgage again, it could earn $16,000 per year. The economic value of the old mortgage loan—discounted by the higher interest rate—falls roughly in half, to $57,000 (assuming the mortgage is held until maturity).7 However, under “generally accepted accounting principles,” referred to as GAAP, the mortgage remains on the thrift’s books at its “book value” of $100,000, unless the mortgage is actually sold at the lower value, in which case the loss in value must be written off.8

6Passage of the FIRREA does not mean that the problems created by general forbearance are gone for good. There are strong reasons to believe that over the decade many banks and thrifts, perhaps numbering in the thousands, will close because of increasing competition among financial institutions. For a discussion of the problems facing smaller banks, see Sherrill Shaffer, “Challenges to Small Banks’ Survival,” this Business Review (September/October 1989). For an overview of the problems faced by the banking system and some suggested solutions, many of whom already widely accepted, see George J. Benston and others (1986).

7The effect of a change in interest rates on the value of a mortgage can be calculated using discounted present value. The monthly payment on a 30-year mortgage debt of $100,000 at 8 percent interest is $714.40. The discounted value of a payment 1 months from now is $714.40/(1.00512) and the present discounted value of the mortgage is the sum of these values as j goes from 1 to 360. When the interest rate rises to 16 percent, the denominator increases to (1.16)12/12 and the sum falls, to $56,735.

8Under the looser regulatory accounting principles used by thrifts in the 1980s, the value lost when mortgages were sold did not have to be written off all at once.
The key point is that the economic value of the mortgage is what the market is willing to pay if the thrift is closed. Suppose the thrift has on its books $2 million in deposits, $2 million in mortgages at 8 percent, and $200,000 in cash on hand. Its GAAP net worth is thus $200,000. But with mortgage rates at 16 percent, the economic value of the mortgages is just $1.14 million and the thrift is then economically insolvent. If the thrift were closed and its assets sold to repay depositors, the deposit insurer would have to provide $660,000 to fully pay off the depositors.

On the other hand, mortgage rates may well return to their previous rate of 8 percent. If the thrift is well managed, it might be desirable to wait to see if interest rates will drop and the thrift can return to solvency. The corresponding danger is that the mortgages earn only $160,000 per year. If the thrift must pay more than that in interest on its deposits—as would be likely in a period of high interest rates—the thrift will lose money while the regulators delay closure.

Should Loans Be “Marked to Market”? Some argue that mortgages and other loans should be “marked to market”—that is, their accounting value should equal their economic value. The existence of secondary markets, on which existing mortgages and other loans can be bought and sold, provides a basis for pricing a wide variety of assets. For example, if bank loans to Mexico are priced on the secondary market at 65 cents on the dollar, a bank with $100 million of Mexican loans would have to report this as an asset worth $65 million.

An important caveat is that the market may not always be a good guide to asset valuation. Some secondary markets are very thin—with low-volume, infrequent trading—and may not be representative of the assets we want to value. And at times even very large markets may experience disruptions that distort value.

Under GAAP, loans are entered as assets at their book value, so an institution that is insolvent when marked-to-market may well not be technically insolvent. When this occurs, it may not be legally possible to close the bank or thrift. Moreover, if such a bank or thrift is closed by regulators, the owners often can sue the regulators, arguing that the bureaucrats have unreasonably deprived the owners of property. One step the deposit insurer can take to protect itself is to remove deposit-insurance protection from new deposits to the institution. Then the bank or thrift will typically be unable to attract new deposits and will become insolvent as its deposit base declines.

On the other hand, determining legal insolvency by marking-to-market might force regulators to close an efficiently managed bank or thrift simply because it became insolvent temporarily. And it is possible that marking-to-market itself may induce imperfect measurement of assets if the market does not accurately represent the value of the bank’s assets, a situation that would exacerbate the potential mistakes of forced closure. Indeed, in the late 1970s and early 1980s, Congress and thrift regulators felt that even the GAAP rules were too harsh in the rising-interest-rate environment of that period. Unfortunately, their decision to move toward general forbearance proved extremely costly.

WHY GENERAL FORBEARANCE HAS BEEN SO COSTLY Severe problems accompanied general forbearance. These problems are considerably more evident with hindsight than they were when the policy was being implemented in the early 1980s.

First, and probably most important, general forbearance raises the monetary losses of the insurer and thus the direct costs of deposit premiums. After all, deposit insurance subsidizes insolvent banks and thrifts, and the longer regulators allow them to stay in business, the larger the costs ultimately charged to the deposit-insurance fund.
Permits Excessive Risk-Taking by Banks. A bank that is failing may seek to avoid bankruptcy by taking greater risks. In this case, the motives to generate profit and continue in business may conflict with the traditional principles of carefully assessing the risks and returns to lending.

For example, consider the profit motives of an insolvent thrift in the Southwest that must decide whether to lend additional funds to a large real-estate developer in the area. If the whole real-estate market in the area has gone sour, the developer is likely to go bankrupt, even with the infusion of cash. But as long as the market remains bad, the thrift itself has no hope of a return to solvency. If the market does turn around, the developer will be able to repay the loan and the thrift will no longer be insolvent. The decision to make the loan pushes the thrift deeper into danger. But if the developer’s venture is successful, the thrift’s shareholders will be the beneficiaries. If it is not, the cost of failure will be borne entirely by the deposit insurer.

An additional risk of general forbearance is that insolvent banks are temptations for fraud. An insolvent bank is a tempting target for a crook, because it may be for sale at a low price. The crook can then make loans to his own enterprises or to cohorts at concessionary rates, siphoning dollars out of the bank.

"Zombie" Thrifts Can Exacerbate the Problem. Allowing inefficient banks to remain in business under a policy of general forbearance imposes social costs on other banks and the community. When inefficient insolvent banks compete aggressively for deposits and loan business, they can harm better-managed banks, which are forced to compete in a deteriorating environment. Professor Edward Kane has dubbed such insolvent thrifts "zombie thrifts," to underscore how the "living dead" can bring about more of their own kind, multiplying the problems of the insurance system.10

WHY EFFICIENT CLOSURE IS SUPERIOR TO QUICK CLOSURE

Undeniably, many of the problems of forbearance can be solved by quick closure. Quick closure reduces the monetary losses of the insurer, and this has the fundamental benefit of protecting taxpayers from losses. Not incidentally, it also will tend to result in lower deposit premiums. In addition, by making it likelier that a bank encountering difficulties will be closed, quick closure guards against excessive risk-taking by banks. Fearing bad outcomes that may lead to quick closure, banks will tend to take steps to raise their capital and make less risky loans. Finally, quick closure closes banks that, because of their weak balance sheets, would be most likely to engage in risky or fraudulent behavior.

Unfortunately, quick closure increases the number of efficient banks that are closed or merged when they experience what otherwise would be a temporary setback. When efficient banks close, valuable resources to the community are lost. Goodwill and expertise, the building blocks for business centers, are sacrificed.

If a region’s major industry suffers a severe blow—as when an agricultural community suffers a prolonged drought or when an oil-producing state is hit by low energy prices—both well-managed and poorly managed banks may show losses and become insolvent. Under quick closure, both types of banks would be closed, and the region would suffer an additional blow that could harm its ability to recover.

9The FIRREA widens the authority of regulators to disapprove bank and thrift directors and senior executives, and it strengthens criminal penalties for misconduct.

Typically, the well-managed bank will have fully reported its losses, and with sound banking practices it will be able to return to profitability in short order. But the poorly managed bank often will not have a good system for reporting its losses, and its return to profitability will be prevented because of old and new mistakes. To the extent that regulators can efficiently sort out good and bad banks, costs will be minimized and benefits to the community will be greatest.

Banks Must Not Avoid Risk. Quick closure also increases regulatory interference in bank conduct. In particular, it may have the chilling effect of making banks too averse to risk. The business of banking is to manage risk in lending through diversification and through knowledge of the business scene. It is important for banks to know that if they are fundamentally sound, they will be given the opportunity to return to profitability. That way, they will be more willing to pursue profitable but risky lending, which helps keep the U.S. economy flexible and growing.

IMPROVING PRIVATE INCENTIVES

Closing banks whenever losses are possible is obviously not the best way to regulate bank risk. The focus should be on enhancing the efficiency of closure decisions—first by increasing shareholders’ incentives to close and merge inefficient banks, and then by improving the information regulators can use to identify and close inefficient banks.

A bank’s shareholders are the most likely party to know when a solvent bank is losing money. Giving shareholders the right incentives to close or merge an inefficient bank increases the presumption that banks that remain open are efficient. This places less of a burden on regulators to close solvent institutions and permits them to focus more keenly on insolvent institutions.

Risk-based Deposit Premiums and Capital Requirements. One way to provide the right incentives to shareholders is to base deposit premiums on a bank’s level of risk. When a nearly insolvent bank has to pay fully for its riskiness, its incentive to stay independent diminishes. Unfortunately, setting premiums to the right amount is an extremely difficult task. Current proposals, which set premiums based on the composition of the bank’s assets, go only part way toward capturing the bank’s riskiness, but are a step in the right direction.

Another step toward improving private incentives is risk-based capital requirements. In 1988, the United States and 11 other nations signed an agreement establishing minimum risk-based capital requirements for banks, to be phased in by 1992. Under this system, banks investing in riskier assets will have to raise additional capital, which will provide additional protection for the FDIC against losses. This will tend to discourage weak banks from taking risky positions. However, the provisions are quite broad and do not cover all forms of risk-taking; the risk of interest rate movements, for example, is not included.

Since setting risk-based deposit premiums and capital requirements properly is likely to be imperfect, it is also crucial to provide bank regulators with better information.

IMPROVING INFORMATION FOR CLOSURE

Proposals to provide regulators with better information begin with timely and accurate financial reporting. In principle, accounting practices and appraisals would use current market values of assets and liabilities to accurately reflect economic solvency. At a minimum, banks and thrifts would report the market value of assets whenever accurate pricing is possible.

If such information on economic solvency were available, then more careful consideration could be given to proposals that permit regulators to close or merge institutions that are near economic insolvency. But to avoid the
undesirable effects of quick closure under such proposals, regulators would have to retain substantial discretion to keep open banks and thrifts that can show they are well managed.

The FIRREA encourages better accounting information by increasing the penalties for false reporting of assets. For the first time, the accounting firms hired by banks and thrifts can face severe penalties for countenancing false reporting.

But accurate accounting data are not enough to assure efficient closure, and the information of all parties should be brought to bear. Several current proposals make it more likely that depositors, capital markets, and even other banks will signal to regulators a lack of faith in particular banks, buttressing the early warning signals currently in use. But some of these proposals also have pitfalls.

Information from Depositors. Some depositors may know a lot about their bank and its fortunes. Large depositors at a small bank, for example, may know how its portfolio is doing because they are deeply involved in the local business environment.

Moreover, if deposit-insurance protection is reduced below 100 percent—a idea known as “co-insurance”—depositors are more likely to signal failures by moving funds from risky or failing institutions. One form of this proposal is to reduce the maximum-size deposit protected by insurance. The idea here is that the most savvy depositors are likely to be large depositors, and a run of their deposits can signal insurers of impending trouble.11

The drawback to co-insurance is that depositors’ runs were the problem in the first place. Deposit insurance exists largely because depositors’ information and incentives all too often led to failures of good banks. Co-insurance may provide a useful signal, but if depositors act on poor information, they may make aiding good banks harder rather than easier.

Information from Other Banks. Before the system of deposit insurance was created, clearing houses, which were consortia of banks, successfully propped up banks threatened by panics. They were successful largely because competitors are often in the best position to judge whether a rival bank is well managed.12

Professor Charles Calomiris has pointed out that these consortia sometimes have acted very successfully as mutual deposit-insurance groups, precisely because banks had good information about one another.13 Calomiris proposes to make groups of banks responsible for one another in just this way.

The mutual-insurance concept may no longer be credible, however, given the FIRREA. A key to mutual insurance is the fundamental notion that the group suffers when any bank goes under. This mutual dependence ensures that banks have a strong incentive to report bad banks. If banks interpret FIRREA to mean that taxpayers will bail out the insurance fund in the future, then the banking industry has little incentive to help construct sound rules for bank closure. If banks pay the full cost of deposit insurance, they will have a strong interest in seeing that closure is quick and efficient.

Information from Capital Markets. At present, regulators are keen observers of banks’ stock prices and costs of funds, and the capital markets are thus useful in signaling bank problems. But most banks and thrifts have stocks


12There is a risk, however, that even a well-managed bank may be forced out of business by rivals seeking to reduce competition.

that either are not publicly traded or are traded on thin markets.

One way to obtain additional information from capital markets is to raise capital standards. This forces banks and thrifts to raise cash outside the umbrella of deposit insurance. Under FIRREA, thrifts are required to meet the higher capital standards that banks face. This requirement is forcing thrifts to raise additional equity, borrow money from capital markets, or shrink their assets. But before a thrift can convince lenders to put up new cash, its management must provide credible information that the thrift will remain profitable. While a powerful sign of creditworthiness, raising additional equity or debt is not a panacea. For example, given widespread press reports of problems in the S&L industry, good thrifts may be unable to convince outside investors that they are sound.

Limits on Assets of Banks and Thrifts. A final way to reduce the problem of insufficient information is to limit the types of assets banks and thrifts can hold. Such a move would make it easier to evaluate the performance of the institution and its management, simply by reducing the number of asset categories regulators would need information about. At the extreme end are proposals to create "safe banks," which would be restricted to holding extremely safe assets such as U.S. Treasury bills. However, an important rationale for deposit insurance is to ensure that banks and thrifts are able to lend to businesses and consumers. Preventing these loans would harm the economy's ability to allocate savings to those who would use them best.

Among the less radical reform proposals are those that suggest reining in the ability of banks and thrifts to diversify into risky assets and to limit the expansion of their powers into new areas, such as direct real-estate investment or securities underwriting. In particular, the FIRREA requires thrifts to keep nearly 70 percent of their assets in mortgage-related investments. A drawback of this requirement, however, is that it prevents possible diversification of portfolios, which, if properly managed, can reduce the risk of bank failure.

CONCLUSION

Under the current system of deposit insurance, troubled banks and thrifts do not have the right incentives to close themselves, and failing banks have incentives to jeopardize the funds with which they are entrusted. Consequently, the job of closing failing banks falls to the deposit insurer. If the deposit insurer fails to do so—or is somehow prevented from doing so—then losses from deposit insurance will inevitably multiply.

Vigorous closure of inefficient banks and thrifts is crucial to the health of our deposit insurance system. But vigorous closure is an aim that needs to be buttressed by 1) reducing the subsidy to risky and inefficient banks and thrifts, via risk-based deposit-insurance premiums and capital requirements; 2) improving the accuracy of information provided to insurers and other regulators; and 3) giving all parties concerned more incentives to signal to insurers their lack of faith in inefficient banks and thrifts—and their faith in efficient ones.