

Federal Deposit Insurance: The Case For Radical Reform

by

A. James Meigs

and

John C. Goodman

NCPA Policy Report No. 155

December 1990

**This study is made possible in part by a grant
from the George Edward Durell Foundation**

National Center for Policy Analysis

12655 N. Central Expressway, Suite 720

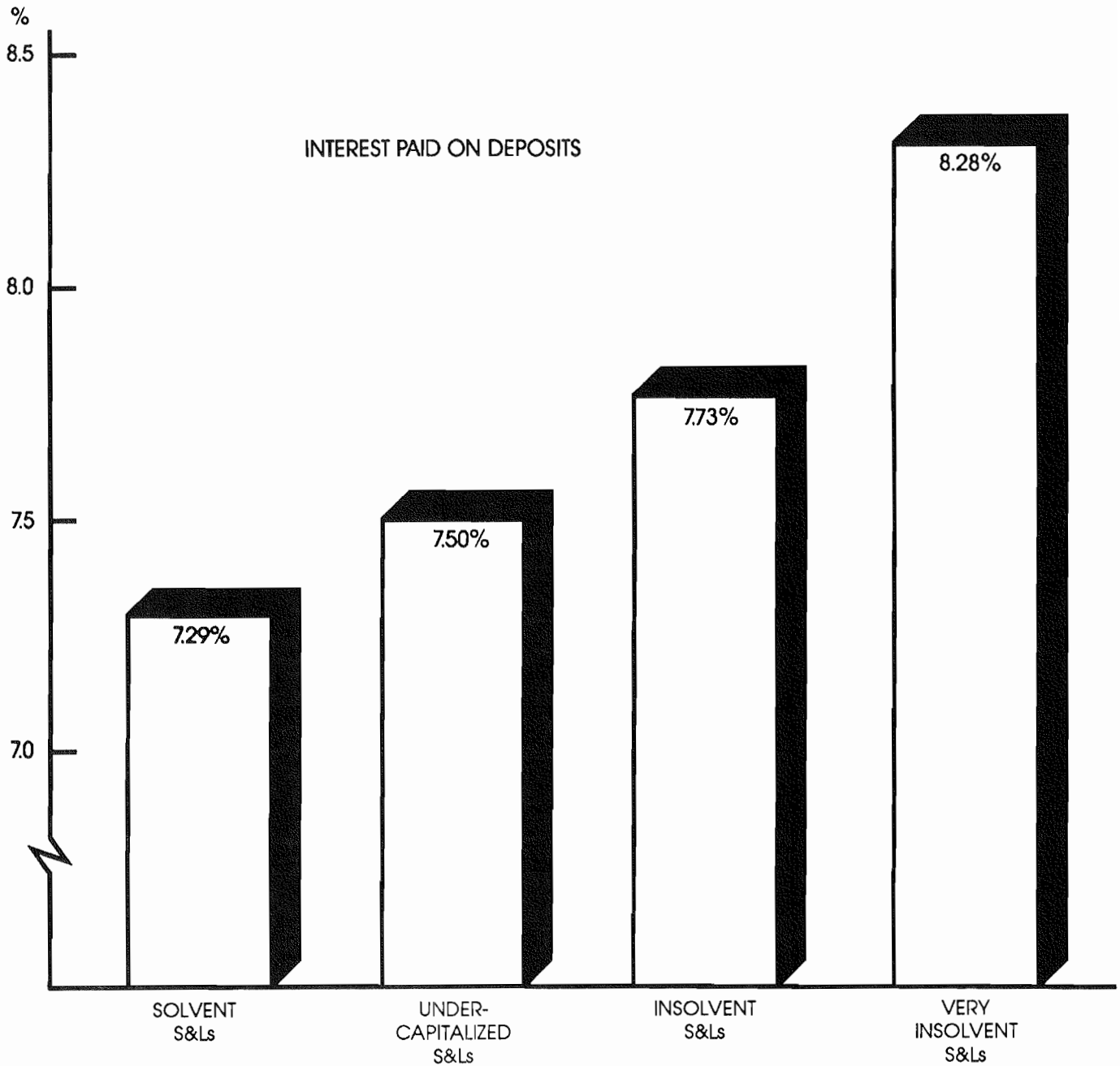
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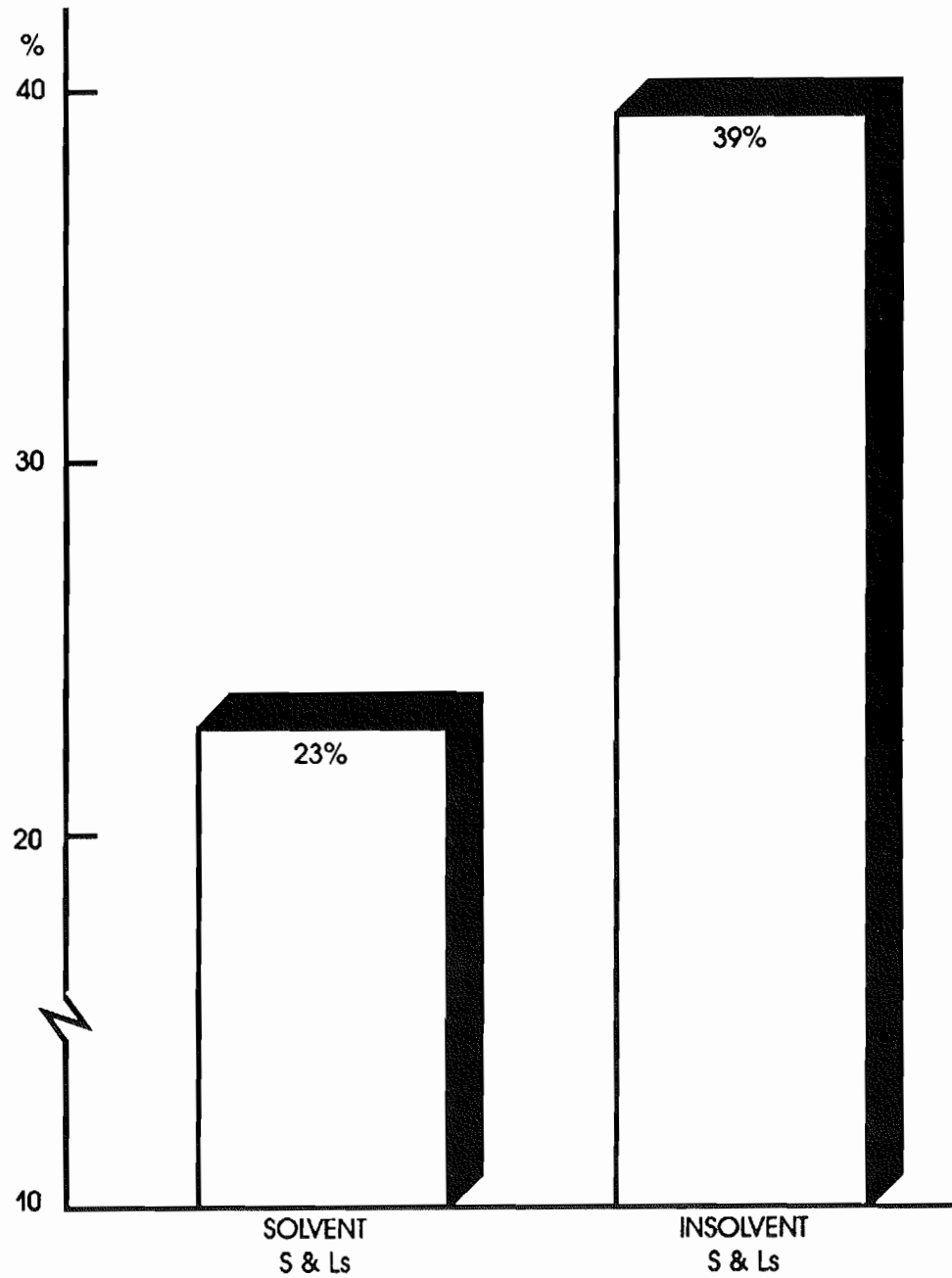
CHOICES FOR SAVERS IN TEXAS

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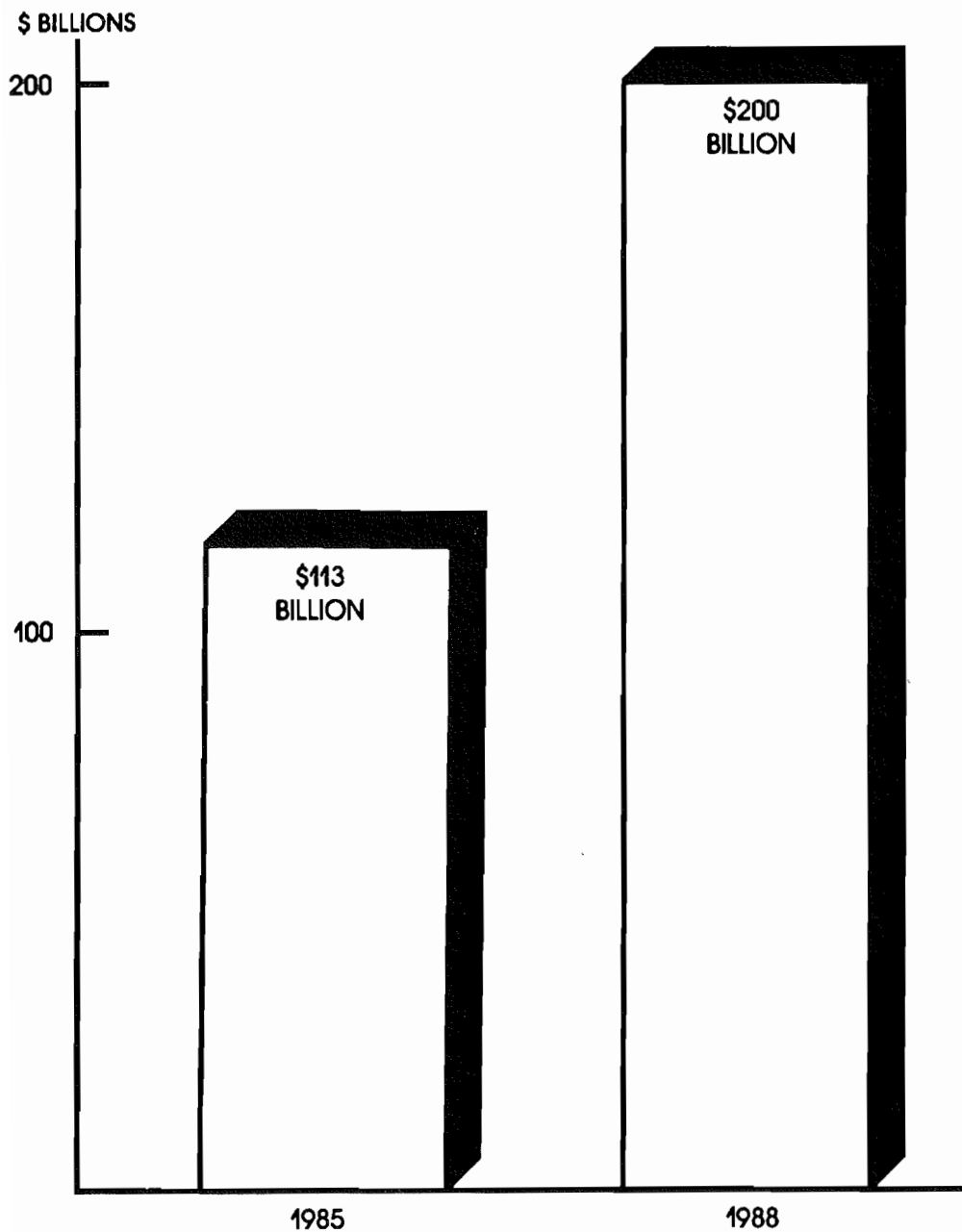


RESPONSE TO INCENTIVES: S&L GROWTH IN TEXAS* (1980-1984)



*GROWTH BY ASSETS. Part of the growth of assets of insolvent S&Ls reflects shifts of some S&Ls from solvency to insolvency during the period.

DEPOSITS AT INSOLVENT S&LS NATIONWIDE



Executive Summary

The crisis of deposit insurance is not new. Throughout our history, state governments have made many attempts to operate deposit insurance systems:

- In the 19th century, state deposit insurance systems created in Michigan, New York and Vermont all failed.

- In the early part of the 20th century, Kansas, Mississippi, Nebraska, North Dakota, Oklahoma, South Dakota, Texas and Washington established deposit insurance funds for banks — and all failed during the prosperous 1920s.

- More recently, state deposit insurance for savings and loan associations in Maryland, Nebraska and Ohio failed during the prosperous 1980s.

The basic causes of failure have always been the same. Financial institutions are free to make loans based on their own business judgment. But if the loans go bad, deposit insurance covers the losses. Since the premiums that support the system never accurately reflect the riskiness of bank portfolios, healthy banks are penalized and find ways to leave the system. As the losses mount and the premiums increase, all but the least healthy banks leave the system. Eventually, the losses far exceed the premiums the system can collect from the remaining marginal institutions.

This historical experience is being repeated at the federal level today. Having endured the total collapse of deposit insurance for S&Ls, we may be in danger of a similar collapse of deposit insurance for commercial banks:

- In the 1980s, the level and costs of bank failures were greater than at any time since the Great Depression.

- In 1988 alone, federal regulators sold or liquidated 200 banks with \$35.7 billion in assets — more than one-third of all the assets of all bank failures resolved by regulators in the history of federal deposit insurance.

The market response to this crisis is predictable.

- Currently, as much as one-third of the U.S. (M2) money supply is outside the federal deposit insurance system.

- In response to mounting losses, deposit insurance premiums are being increased by more than 60 percent — for all banks.

- The premium increase will encourage an even larger exodus of funds from the system.

No private or public deposit insurance scheme has ever been successful over a long period of time. Fortunately, such schemes are not necessary to protect the public or to maintain a sound financial system. Depositors can secure the full faith and credit of the federal government by opening accounts backed by government securities, eliminating any need for deposit insurance. The Federal Reserve System can maintain the nation's money supply independent of the failure of individual banks. With appropriate deregulation, market forces can create a healthy commercial banking sector similar to Canada's — where not a single bank failed during the Great Depression.

What Is the S&L Crisis?

Hundreds of S&Ls have gone bankrupt in less than a decade. The value of their assets (loan portfolios) fell short of their liabilities (mainly customer deposits) by more than \$150 billion. Since they could not possibly pay off depositors and other creditors with their own resources, they are insolvent. There has not been a banking crisis of this magnitude in the United States since about 9,000 banks and several hundred savings and loan associations failed during the Great Depression of the 1930s.

Why Is the S&L Crisis Costing Taxpayers Money?

Taxpayers are liable because the federal government insures deposits of banks and S&Ls in amounts up to \$100,000. This means that if an S&L cannot return its depositors' funds, the federal government will do so. For example:¹

- Federal deposit insurance currently covers about 75 percent of all bank deposits — an amount equal to about \$1.7 trillion (75% of \$2.25 trillion).
- Federal deposit insurance covers about 98 percent of all S&L deposits — or about \$950 billion.

Even deposits that are not technically insured (deposits in excess of \$100,000) appear to be insured de facto because of an unwritten federal policy regarding banks that are “too big to fail.”² Since 1985, the federal government has protected 99.5 percent of uninsured deposits in all closed banks.³

Federal deposit insurance agencies were originally meant to be self-supporting. They were supposed to collect from all member institutions

premiums sufficient to make good the deposits of failed institutions. The losses of the S&Ls, however, are far greater than the resources of the agency that once insured them. As a result, taxpayers will be forced to make up the difference.

How Much Will It Cost?

No one knows what the exact cost will be, and estimates are revised almost daily. Table I presents one estimate published in the *Stanford Law and Policy Review*: According to the table:

- The cost of the S&L bailout over the next decade will be almost \$500 billion, or about \$2,000 for every man, woman and child in the country.
- This cost includes about \$217 billion in interest payments — because the federal government is financing the bailout through on-budget and off-budget borrowing instead of meeting the cost out of current revenue.

Burdens for Taxpayers. The taxpayers' obligations will not end in the year 2000, however. Most of the borrowed funds used to bail out S&Ls are being financed by 30- or 40-year bonds. When the interest on these bonds is considered, the total cost will be much greater than the numbers usually reported. As Table II shows:

- Through the year 2029, the total cost of the S&L bailout will approach \$1.4 trillion.
- This amounts to about \$5,500 for every person in America.

It is important to note that the estimates in Tables I and II do not represent the worst that could happen. These figures are based on the relatively conservative assumption that the “base cost” S&L closings (after January 1990) will be \$124 billion.

Yet one 1990 study showed that this estimate is too low. Based on recent closing costs, the additional closings could easily cost \$190 billion or 50 percent more.⁴ If the higher estimate proves to be correct, interest and other costs will also be much higher.

Burden for the Economy. In addition to the estimates of taxpayer costs shown in Tables I and II, there are real costs to the U.S. economy. These costs consist of other resources that were wasted when S&Ls made bad investments and are evidenced by "the vacant office buildings, abandoned real estate development projects and unprofitable business ventures that comprise the bad assets of bankrupt thrifts."⁵ Even though some of these buildings and projects will eventually be salvaged, the U.S. economy would be far better off today if the depositors' funds had been invested more wisely.

Why Is There So Much Uncertainty about the Cost of the Bailout?

One reason is that S&Ls do not keep financial records that would allow us to make accurate assessments of their financial health. Economists are virtually unanimous in the belief that the correct basis for evaluating an S&L is the *market value* of its assets and liabilities. Yet 50 years of federal regulations and financial industry opposition have prevented this type of accounting. Under the influence of federal policy, generally accepted accounting principles (GAAP) and regulatory accounting principles (RAP) evaluate loans based on their historical value

TABLE I

Cost of the S&L Bailout By the Year 2000¹

(\$ Billions)

Old Cases Expense (Up to Jan. 1990)	\$ 68.0
New Cases Expense (After Jan. 1990)	124.0
Savings Assoc. Insurance Fund	8.8
Administrative Costs	19.0
Lost Tax Revenue from FSLIC Deals	9.0
Zero Coupon Bonds to Repay	
Non-Treasury Debt	11.0
Interest Expense: ²	
Treasury Interest	95.8
Non-Treasury Interest	92.7
Interest on Working Capital	28.0
TOTAL	\$456.3

¹Based on the estimate of the Office of Management and Budget (OMB) plus off-budget spending plus \$50 billion additional needed to meet the expense of new users plus General Accounting Office (GAO) estimates of additional expenses.

²Assumes Treasury borrowing at 8.5 percent interest and non-Treasury borrowing at 8.75 percent interest.

Source: G. Christian Hill, "A Never Ending Story: An Introduction to the S&L Symposium," *Stanford Law and Policy Review*, Vol. 2, No. 1, Spring 1990, Table 1, p. 23.

TABLE II

Cost of the S&L Bailout Over the Next 40 Years: 1989 - 2029¹

(\$ Billions)

First Ten-Year Cost (1989 - 1999) ²	\$ 456.3
Non-Treasury Debt, 2000 - 2029	274.8
Treasury Debt, 2000 - 2029	638.8
TOTAL	\$1,369.9

¹Assumes only interest costs in year 2000 and beyond. Excludes the interest cost of borrowing to pay interest.

²From Table I.

Source: G. Christian Hill, "A Never Ending Story: An Introduction to the S&L Symposium," *Stanford Law and Policy Review*, Vol. 2, No. 1, Spring 1990, Table 2, p. 24.

rather than their current market value.⁶ Not only do these accounting techniques conceal the true picture, but, when combined with other regulations, they have enabled S&Ls (and their insurers) to make their financial health look better on paper than it is in fact.⁷

A second reason for the uncertainty is that even with proper accounting it is very difficult to determine the value of an ongoing enterprise. In many cases, federal agencies have made guarantees to healthy institutions to take over the portfolios of troubled S&Ls. In these cases the federal government (and therefore the taxpayer) is a “partner” in a venture with an uncertain future.

A third reason is that federal regulatory agencies — those in the best position to know the facts — have persistently suppressed critical information.⁸ Official acknowledgement of the dimensions of the crisis has emerged slowly, even though official awareness has existed for many years.

A fourth reason is that no one can predict the precise sales prices of the institutions and their assets when they are sold or disposed of by the Resolution Trust Corporation (RTC)—the agency that is supervising the S&L bailout. In the original bailout plan adopted in the Financial Institutions Recovery, Reform and Enforcement Act (FIRREA), the RTC was to have a revolving fund of \$50 billion in working capital, which it was expected to replenish from sales of institutions and assets. The RTC has repeatedly gone to Congress for more cash, however, as the actual proceeds of asset sales have fallen short of the projections. For example, William Seidman, chairman of the Resolution Trust Corporation, told the House Ways and Means Committee on September 19, 1990 that the agency will need roughly \$122 billion in funding for the fiscal year beginning October 1. That is

more than double what was anticipated a year earlier.⁹

What Caused the Problem?

There is almost universal agreement among economists on the basic causes of the S&L crisis. This consensus extends from the Urban Institute and the Brookings Institution on the left to the Hoover Institution and the Cato Institute on the right. The basic cause is federal deposit insurance and the complex system of regulations that surround it. Briefly stated, other federal government policies caused the bankruptcy of the S&L industry, while federal deposit insurance increased the cost of that bankruptcy and made taxpayers liable for the bailout.

Creating an Artificial Industry. The S&L industry in the 1970s was not a natural outgrowth of competition in the free marketplace. Instead, it was largely an artificial creation of Depression-era policies. Congress gave S&Ls special powers and subsidies and required them to concentrate on serving the housing industry. Unfortunately, these policies made S&Ls highly vulnerable to the effects of inflation.

Effects of Inflation. The Federal Reserve System’s expansion of the money supply in the 1970s led to inflation that persisted into the 1980s. Inflation caused interest rates to rise,¹⁰ and the results were devastating for S&Ls. The industry’s assets consisted largely of long-term loans made at fixed, low rates of interest negotiated in pre-inflation days. Yet in order to attract deposits, S&Ls had to pay high short-term interest rates which varied with the rate of inflation. No financial institution can survive for long if its income is based on a lower rate than its cost of funds.

Unfolding Revelations about the S&L Crisis

<u>Date</u>	<u>Event</u>
Spring 1985	In the <i>Economic Report of the President</i> , the Council of Economic Advisers reports a rising tide of bank and S&L failures, and reports that the Administration and federal regulatory agencies have begun a study to reassess federal deposit insurance. ¹
March 1985	According to <i>Newsweek</i> , an employee of the Federal Home Loan Bank board was allegedly discharged for leaking an internal estimate that it will cost \$10 billion to clean up the savings and loan problem. ²
Fall 1985	The first published estimate says the federal deposit insurance fund for S&Ls is technically bankrupt and predicts a bailout cost of \$15.8 billion. ³
Fall 1985	The Federal Home Loan Bank board admits the five-year costs of bailout could be as high as \$22.5 billion. ⁴
Spring 1986	The Treasury Department releases its first official estimate of a \$10.8 billion cost. ⁵
December 1986	The Federal Home Loan Bank board estimates that \$10.5 billion would cover resolutions of institutions that were on the FSLIC case list on December 31, 1986. ⁶
Spring 1986	The <i>Economic Report of the President</i> contains an entire chapter on the federal role in credit markets and warns of the dangers created by perverse incentives in the deposit insurance system. ⁷
Spring 1987	The administration asks for an appropriation of \$15 billion to recapitalize the FSLIC so that it can close insolvent S&Ls. Congress responds by authorizing \$10.8 billion in the Competitive Equality Banking Act of 1987 (CEBA). ⁸
May 1987	The General Accounting Office estimates that \$26 billion to \$36 billion will be required to resolve the cases on FSLIC's books in December 1986. ⁹
July 1988	M. Danny Wall, chairman of the Federal Home Loan Bank board, estimates that FSLIC will need \$42.5 billion through the next ten years to deal with the crisis. ¹⁰
August 1988	William Seidman, chairman of the FDIC, says \$50 billion will be required. ¹¹
August 1989	The Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) is projected to cost \$40 billion for 1988 insolvencies, \$50 billion to close currently insolvent institutions, \$33 billion for future costs and \$43 billion for interest costs, for a total of \$166 billion through 1999. ¹²
April 1990	Bert Ely, a private consultant and leading authority on S&Ls, estimates that it will cost \$125 billion to resolve the thrift crisis, including \$50 billion for pre-1989 resolutions and excluding future interest costs. ¹³

- April 1990** James Barth of Auburn University and Dan Brumbaugh of Stanford estimate that resolving thrifts will cost \$91 billion to \$135 billion, excluding pre-1989 resolutions and future interest costs.¹⁴
- May 1990** Treasury Secretary Brady's estimate of borrowings for the bailout is interpreted to mean total costs of between \$90 billion and \$130 billion. This does not include interest costs or the \$52 billion incurred by the FSLIC for pre-1989 bailouts.¹⁵
- May 1990** William Seidman, chairman of the FDC, estimates that \$64.9 billion will be required to honor agreements entered into by FSLIC for supporting or closing insolvent institutions before 1989.¹⁶
- June 1990** Secretary Brady announces that a further \$30 billion to \$50 billion will be needed for the thrift bailout next year. Without new cash the bailout effort will be out of money by year end.¹⁷
- June 1990** The Congressional Budget Office (CBO) raises its estimate of the cost of resolving S&Ls to \$150 billion, excluding interest.¹⁸
- September 1990** The General Accounting Office, investigative arm of Congress, increases its estimate of total bailout costs to between \$335 billion and \$370 billion, up from its earlier \$235 billion.¹⁹

¹*Economic Report of the President*, transmitted to the Congress, February 1985 (United States Government Printing Office, Washington, DC), pp. 37-39.

²*Newsweek*, June 4, 1990.

³James R. Barth, R. Dan Brumbaugh, Jr., Daniel Saerhaft and George H. K. Wang, "Insolvency and Risk-Taking in the Thrift Industry: Implications for the Future," *Contemporary Policy Issues*, Fall 1985, pp. 1-32.

⁴Edwin J. Gray, chairman, Federal Home Loan Bank Board. Address before the Annual Convention of the U.S. League of Savings Institutions, Dallas, TX, November 5, 1985.

⁵*Newsweek*, June 4, 1990.

⁶James R. Barth and Philip F. Bartholomew, "The Thrift-Industry Crisis: Revealed Weaknesses in the Federal Deposit Insurance System," Paper prepared for Conference on Reform of Deposit Insurance and the Regulation of Depository Institutions in the 1990s., notes to Chart I.

⁷*Economic Report of the President*, transmitted to the Congress February 1986, (United States Government Printing Office, Washington, DC), pp. 189-212. See also, William A. Niskanen, *Reaganomics: An Insider's Account of the Policies and the People* (New York: Oxford University Press, 1988).

⁸Both of these estimates were much too low at a time when the FSLIC was about to become deeply insolvent, never to recover. See W. Lee Hoskins, "Reforming the Banking and Thrift Industries: Assessing Regulation and Risk," Frank M. Engle Lecture, The American College, Bryn Mawr, PA, May 22, 1989.

⁹Barth and Bartholomew, "The Thrift-Industry Crisis," notes to Chart I.

¹⁰Clifford F. Thies and Daniel A. Gerlowski, "Deposit Insurance: A History of Failure," *Cato Journal*, Vol. 8, No. 3 (Winter 1989), p. 690.

¹¹*Ibid.*

¹²Dwight M. Jaffee, "Symposium on Federal Deposit Insurance for S&L Institutions," *Journal of Economic Perspectives*, Fall 1989, p. 61.

¹³Barth and Bartholomew, "The Thrift-Industry Crisis," notes to Chart I.

¹⁴Barth and Bartholomew, "The Thrift-Industry Crisis," notes to Chart I.

¹⁵"Brady Says Cost of S&L Bailout Could Double," *Wall Street Journal*, May 24, 1990.

¹⁶Testimony of L. William Seidman on FSLIC Resolution Fund Appropriations for Fiscal Year 1991 before the subcommittee on HUD, VA and Independent Agencies Committee on Appropriations, United States Senate, May 23, 1990.

¹⁷"Brady Says S&L Bailout Cost Expected to Increase by as Much as \$50 Billion," *Wall Street Journal*, June 15, 1990.

¹⁸As recently as March 1990, the CBO estimated that it would cost \$80 billion to deal with the S&Ls then under government control. The new projection assumes that more S&Ls will be seized and that losses will increase. "Estimate of Bailout Cost for Thrifts Is Increased," *Wall Street Journal*, June 14, 1990.

¹⁹"RTC Chief Totals Growing Expenses of Thrift Bailout," *Wall Street Journal*, September 20, 1990.

Table III shows calculations of the net worth of the S&L industry throughout the 1970s. These calculations are based on the market value of assets rather than the normal regulatory accounting methods which are conventionally used. As the table shows:¹¹

- The S&L industry as a whole had a negative net worth as early as 1971 — long before the financial deregulation of the 1980s.
- By 1981, liabilities of the entire S&L industry exceeded assets by \$150 billion.

■ This S&L liability was about 25 times larger than the reserves the federal government had set aside to pay off depositors in case of S&L failures.

New Policies in the 1980s: Forbearance, Deregulation and Higher Limits on Deposit Insurance. Every lending officer is occasionally tempted to stretch the institution's credit limits to help a customer in trouble. Sometimes this means throwing good money after bad. At other times additional credit may help a troubled borrower become a bigger and better customer. In such cases, prudence requires that the lender keep a

close eye on how the additional credit is used, however. The federal government was in this position with respect to troubled S&Ls in the 1980s. But its actions were anything but prudent. Rather than closing institutions that were technically bankrupt, federal supervisors followed the will of Congress and the Administration, practicing a policy of "forbearance" and hoping that troubled institutions would "grow out of their problems."

Many S&Ls that tried to do so, however, often succeeded only in making those problems worse. They added loan-quality risks to their interest rate risks. S&Ls with large portfolios of old, low-interest mortgages sought to attract new deposits by paying high interest rates and making risky investments. This helps to explain the extraordinary growth of S&Ls in 1983-85, when some institutions multiplied in size.

Taxpayer exposure became even greater when federal deposit insurance

TABLE III

Net Worth of Savings and Loan Institutions and Reserves For Deposit Insurance

(\$ Billions)

<u>Date</u>	<u>Net Worth of S&Ls¹</u>	<u>Reserves for Deposit Insurance²</u>
1971	-\$11.3	\$3.0
1972	-19.3	3.1
1973	-18.4	3.5
1974	-32.6	3.8
1975	-38.4	4.1
1976	-41.5	4.5
1977	-44.5	4.9
1978	-52.7	5.3
1979	-79.3	5.9
1980	-118.0	6.5
1981	-150.5	6.2

¹Calculated using the market value of unrealized mortgage losses.

²Official estimate of the reserves of the Federal Savings and Loan Insurance Corporation (FSLIC).

Sources: Edward J. Kane, *The Gathering Crisis in Federal Deposit Insurance*, (Cambridge: MIT Press, 1985), Table 4.6, p. 102 for net worth; and Edward J. Kane, *The S&L Insurance Mess: How Did It Happen?* (Washington, DC: Urban Institute Press, 1989), Table 1-1, p. 9 for FSLIC reserves.

Note: There are several different ways of measuring net worth. Economists usually prefer using the market value of assets. Other methods are Regulatory Accounting Procedures (RAP) and Generally Accepted Accounting Principles (GAAP).

was extended from \$40,000 per deposit account to \$100,000 in the early 1980s, and when financial deregulation permitted S&Ls to pay higher rates of interest to attract deposits and to make riskier investments in search of higher returns.

Making the Taxpayer a Co-Investor in S&L Ventures. Troubled S&Ls paid above-market rates of interest in order to attract even more deposits — all guaranteed by taxpayers. They made riskier investments because they needed above-market rates of return in order to recoup past losses. Even if their practices had a small chance of working, that chance was doomed by the Tax Reform Act of 1986. Most S&L investments in the 1980s were based on real estate. Tax reform eliminated several tax provisions that had made real estate investments more attractive.¹²

TABLE IV

S&L Losses: Where the Money Went

Pre-1983 Losses	17%
Interest on Pre-1983 Losses	29%
Real Estate Losses	19%
Excess Operating Costs at Insolvent S&Ls	10%
Excess Interest Paid at Insolvent S&Ls	10%
Deteriorated Franchise Costs	5%
Fraud	3%
Excess Cost of FSLIC Deals	3%
Losses on Junk Bonds	2%
Losses on Other Non-Real Estate Investments	2%
TOTAL	100%

Source: Ely & Co. Reprinted in Paulette Thomas, "Fraud is Called Small Factor in S&L Cost," *Wall Street Journal*, July 20, 1990.

The Politicians' Search for a Scapegoat

The economic analysis of the savings and loan crisis places the blame on Washington. Washington seeks villains elsewhere. Some favorites among politicians are: fraud, investments in junk bonds and the financial deregulation which permitted S&Ls to make nontraditional loans. Yet these explanations are not consistent with the facts.

Table IV presents one highly regarded estimate of the various causes of S&L losses. As the table shows:

- About 65 percent — the vast majority — of S&L losses were incurred either before deregulation or in conventional real estate loans.
- Only 3 percent of S&L losses can be attributed to fraud.
- Only 2 percent of S&L losses are attributable to investments in junk bonds.
- Only 2 percent of S&L losses can be attributed to other non-real estate investments.

Other estimates may produce slightly different numbers, but the overall conclusion is unlikely to change.¹³ The evidence is consistent with the economists' explanation. It is inconsistent with the politicians' search for scapegoats.

Is The S&L Bailout Strategy Solving the Problem?

For the most part, no. The one virtue of the S&L bailout act (FIRREA) is that it calls for closing insolvent thrifts and preventing them from creating even more liabilities for taxpayers.¹⁴ Beyond that, FIRREA reflects the politicians' con-

cern with finding scapegoats and ignores the economists' analysis of the root causes of the crisis.¹⁵

FIRREA does not require the industry or the regulatory authorities to adopt any of the fundamental reforms called for by economists. For example, the act does nothing to reform the accounting standards for S&Ls — reform which is necessary so that independent analysts can know what the taxpayers' exposure really is. FIRREA does nothing to limit federal deposit insurance — the vehicle by which taxpayers become liable for losses at financial institutions. FIRREA even encourages or forces S&Ls to repeat the investment strategy that got them in trouble in the first place — over-specializing in real estate lending and lending long on mortgages or mortgage-backed securities while borrowing short at current rates of interest.¹⁶

To its credit, FIRREA does call for the “study” of federal deposit insurance.¹⁷ But any reform proposal must travel a long, hazardous road before it affects actual policies and institutions. The opposition will be ready at multiple veto points in Congress and throughout the federal bureaucracy.¹⁸ A study largely buys time for the defenders of the status quo. It promises little of value because “almost everything that anyone ever wanted to know about deposit insurance has already been studied and published.”¹⁹ As a result of the delay, the public pressure on Congress to make significant changes may decline.²⁰

Is the Crisis Limited to S&Ls?

No. Many of the problems which affect S&Ls also affect commercial banks, and the taxpayers' potential liability is huge. Although banks on the

whole are in much better financial health than the S&L industry, there are good reasons for concern:²¹

- In the 1980s, the level and costs of bank failures were greater than at any time since the Great Depression.
- In 1988 alone, federal regulators sold or liquidated 200 banks with \$35.7 billion in assets — more than one-third of all the assets of all bank failures resolved by regulators in the history of federal deposit insurance.
- Since 1984, federal regulators have spent more than \$11.4 billion to resolve failed banks — about 75 percent of the total resolution costs incurred since 1934.

Some analysts fear that the S&L crisis may have diverted attention from serious problems in commercial banking. R. Dan Brumbaugh and Robert E. Litan, for example, believe that the Bank Insurance Fund (which insures the deposits of commercial banks) is perilously close to insolvency. They argue that if it had not been for the gargantuan problems of the S&Ls, the difficulties of the commercial banks and their insurance fund would be an urgent national priority today.²²

Commercial bankers (as represented by the American Bankers Association) agree that the deposit insurance system badly needs to be reformed for banks as well as for S&Ls.²³ However, commercial banks on the average are much better structured for coping with changes in economic and financial conditions than are S&Ls. Most bankers have learned from painful experience how to guard against interest-rate risks through hedging with futures contracts, matching durations of assets and liabilities, and charging floating rates on their loans. Misjudging interest-rate risks is not what has put banks' solvency into question in

recent years.

Some large money-center banks still are coping with nonperforming loans made to less developed countries in the 1970s (encouraged by U.S. bank regulators at the time). Other banks are troubled by loans made to real estate developers and large construction projects in the Northeast and Southwest after the demand for more conventional commercial and industrial loans declined in the 1980s. Bank stockholders are suffering from those miscalculations through lower prices for their stocks. Nevertheless, commercial banks are far more resilient than S&Ls are now, or ever were. Most have the resources and the management talent to handle their problems, especially if they are allowed more freedom of choice among assets and market areas. Although some banks may fail, a wholesale banking collapse that would burden taxpayers the way the S&L crisis has is not likely to happen — especially if we move quickly to reform an unwise system of deposit insurance.

Taking a Closer Look At the Federal Deposit Insurance System

In a normal market, capital tends to flow to its highest valued uses. Firms that are successful and pay high returns to their investors attract more capital, and investors avoid firms that earn low or negative rates of return. In the topsy-turvy world of the banking industry, however, the opposite may happen.

As noted above, the S&L industry had a negative net worth of \$150 billion by 1981. This did not keep the thrift industry from attracting new funds. If anything, the worse things got the more funds the S&Ls managed to acquire. These new funds were

not capital in the sense of owners' net worth. They were other people's capital (in the form of deposits) that S&Ls borrowed to make more loans and to cover earlier losses. The creditors (depositors) were relying on deposit insurance for protection, while enjoying the high rates the S&Ls offered.

■ From 1965 to 1975, S&L industry assets almost tripled, rising from \$130 billion to \$338 billion.

■ From 1975 to 1985, S&L industry assets more than tripled, rising to \$1,069 billion.

Texas financial institutions were particularly troubled because of falling oil prices and the collapse of the Texas real estate market. In the mid-1980s, about half of the S&Ls in Texas were insolvent, and 47 percent of all U.S. bank failures occurred in the state. Yet these troubled conditions did not prevent Texas financial institutions from attracting depositors:²⁴

■ In 1985, there were 37 insolvent S&Ls in Texas with deposits of about \$5 billion.

■ By 1988, the number of insolvent Texas S&Ls had grown to 132, and they had managed to attract \$60 billion in deposits.

Texas mirrored the national experience. Nationwide, deposits at insolvent thrifts almost doubled in three years — rising from \$113 billion in the first quarter of 1985 to almost \$200 billion in the first quarter of 1988.²⁵

How is it that an industry which was sinking deeper and deeper into trouble with each passing year managed to acquire an increasing amount of the nation's financial capital? The answer is federal deposit insurance. Without the backing of the federal government (taxpayers) through deposit insurance, the deposits of insolvent thrifts would have declined. Depositors would have sought

safer places to invest.

How the System Works

Under the original design, there were multiple insurance schemes. The Federal Deposit Insurance Corporation (FDIC) insured commercial banks and mutual savings banks. The Federal Savings and Loan Insurance Corporation (FSLIC — pronounced “fizz-lick”) insured S&Ls until it was closed (because it could not pay claims against it). The National Credit Union Share Insurance Fund or NCUSIF insured credit unions.

Each of the insuring agencies operated under the same principles. First, financial institutions paid a fixed premium which did not vary, regardless of the quality of the loans in its portfolio or its financial health.²⁶ In defiance of sound insurance principles, high-risk institutions (even when hopelessly insolvent) paid the same premium as the financially healthy. Second, the insuring agency promised to reimburse depositors in the event of a bank failure. This reimbursement included not only the original deposit but also the interest on the deposit. This insurance was backed by the “full faith and credit” of the federal government, so that beyond the reserves of the insuring agencies it was an obligation of U.S. taxpayers.²⁷

Under the new (FIRREA) system, the FDIC fund for insuring banks has been renamed the FDIC Bank Insurance Fund and FSLIC has been replaced by the Savings Association Insurance Fund — also administered by the FDIC. Despite these formal changes, there has been little change in the principles governing federal deposit insurance, however.

Table V shows how the maximum deposit covered by the federal guarantee has grown to

\$100,000 since the 1930s. There are good reasons to believe that deposits in excess of \$100,000 are insured de facto, especially if they are held by large banks.²⁸ The federal government is apparently committed to guaranteeing that large banks never fail, and on at least one occasion this policy was officially announced.²⁹ In the case of large bank failures, the regulators almost always transfer a failing bank’s liabilities — both insured and uninsured — to an acquiring bank through a merger. This, in effect, extends the taxpayers’ risk exposure far beyond the original statutory commitment to protect small, unsophisticated depositors. The authorities usually strip many of the bad loans and other problem assets out of failing banks’ portfolios before transferring them to other banks. Taxpayers end up owning the bad loans and problem assets.

Under conditions such as these, bank managers and stockholders of S&Ls and banks know that if they make bad investments part of the losses will be absorbed by the U.S. government (taxpayers). On the other hand, if they make good investments, the government and the taxpayers do not share in the profits, except through the increase in income taxes paid on the profits. Under the heads-I-win-

TABLE V

Maximum Deposit Covered By Federal Deposit Insurance

<u>Date</u>	<u>Amount</u>
1934	\$ 2,500
1950	10,000
1966	15,000
1969	20,000
1974	40,000
1980	100,000

tails-you-lose system of incentives, institutions make riskier investments than they otherwise would.³⁰ There are no large windfall gains for the taxpayers, only windfall losses.

Zombie Thrifts. In the extreme case of a hopelessly insolvent institution, the owners have very strong incentives to roll the financial dice. If their risky decisions fail, they are no worse off — since they were insolvent to begin with. On the other hand, if they guess right and survive bankruptcy through a risky but successful investment strategy, they do not have to share their gains with either the depositors or the insurance agency.

Between 600 and 800 thrift institutions (about 25 percent of the S&Ls) were in this situation by the time the FSLIC became insolvent. Economist Edward Kane has called them “zombie thrifts.” As Kane explains:

The economic life they enjoy is an unnatural life-in-death existence in that, if they had not been insured, the firms’ creditors would have taken control from stockholders once it became clear that their enterprises’ net worth was exhausted. In effect, a zombie has transcended its natural death from accumulated losses by the black magic of federal guarantees.³¹

Hail Mary Passes. The position of a zombie thrift is one in which the owners have every incentive to gamble on a long shot. In doing so, they do not have to rely on their current assets. They can increase their risks by paying above-market interest rates to attract more deposits in order to make even more risky loans. How much an insolvent thrift has to pay to attract new deposits depends upon public perceptions. In a free market, without deposit insurance, alert depositors would shy away

from a troubled institution, thus imposing some market discipline on its managers. With deposit insurance, however, money brokers and other depositors are only too glad to supply a desperate institution with additional deposits and take advantage of higher interest rates.

If people are concerned that in the event of a bank failure the federal government will not reimburse depositors promptly, the interest rate paid will have to be even higher. These apparently were the conditions that prevailed in December 1987. As Table VI shows, insolvent thrifts paid as much as 3.7 percentage points more than the yield on U.S. Treasury bills in order to attract deposits.

In general, the more financially troubled an institution the higher the rate of interest it must pay. Table VII, which depicts interest rates paid by Texas thrift institutions in 1988, shows a direct relationship between the degree of insolvency and the rate of interest paid. Still, these rates would have been even higher had these institutions not been able to transfer much of their portfolio risk to taxpayers, through deposit insurance.

It is important to remember that the deposit insurance agencies do not simply insure the initial deposit of a bank customer. Federal insurance also covers the promised interest, including above-market interest rate promises made by insolvent institutions. In this way, federal deposit insurance subsidizes the attempt by troubled thrifts to lure funds from the healthy sector of the financial markets. To make matters worse, this subsidy is paid for by premiums imposed on healthy institutions and, if necessary, by additional revenues collected from U.S. taxpayers.

Reverse Bank Runs. Prior to the establishment of federal deposit insurance, there were

occasional runs on banks. Once the public became aware that a bank was in trouble, people would begin withdrawing their deposits, thereby making the bank's troubles even worse. In the modern era, we are witnessing the reverse phenomenon.

Take Texas S&Ls, for example. Table VIII shows that insolvent thrifts in Texas were paying high rates of interest to depositors and making mortgage loans with higher rates of interest (reflecting a riskier portfolio). As a consequence of their more attractive rates on deposits, the growth rate for insolvent thrifts was 70 percent higher than the growth rate for solvent thrifts in the early 1980s.

The characteristics of the Texas deposit market reflect a new form of crisis. Today's crisis is not characterized by panics, a generalized loss of confidence or major deposit outflows from insolvent thrifts. To the contrary, in the current environment, depositors recognize that they are putting their funds into insolvent thrifts. Regardless of the size of their deposits, they do not expect to incur financial loss.

Fraud And Mismanagement. Even the most honest of S&L and bank managers have difficulty dealing with the perverse incentives of federal deposit insurance. For the dishonest, these perverse incentives create a gold mine of opportunity. The result is that fraud and other forms of criminal misconduct often are associated with the demise of insolvent financial institutions. Although fraud accounts for only a small amount of S&L losses, fraud appears to

have been present in a large percentage of S&L failures. For example:

- According to the Comptroller of the Currency, fraud and insider abuses contributed to the demise of 35 percent of the banks that failed between 1979 and 1987.³²
- A study conducted by the House Government Operations Committee found misconduct in 80 percent of the S&L insolvencies during the three-and-a-half years ending in June 1987.³³
- As of June 1988, 7,350 bank and S&L cases were under investigation by the FBI and federal grand juries.³⁴

One of the most outrageous cases was Vernon Savings and Loan in Dallas, whose managers are now under criminal indictment. To avoid being shut down by the regulators, Vernon apparently attempted to influence an S&L commissioner with expensive gifts.³⁵ When Vernon was finally seized by federal regulators in 1987, 96 percent of its \$1.3 billion in loans were in default. To make matters worse, intervention by House Speaker Jim Wright delayed the shutdown and allowed Vernon to lend

TABLE VI
Choices for Savers in 1987¹

(Options Backed by the Full Faith and Credit of the Federal Government)

<u>Maturity</u>	<u>Insolvent S&Ls:</u>	
	<u>Interest Paid on</u>	<u>U.S. Treasury Bills</u>
	<u>Certificates of Deposit²</u>	<u>Rate of Interest</u>
1 month	7.22%	3.51%
1-2 months	7.47%	5.05%
2-3 months	7.83%	5.90%

¹As of December 1987.

²In denominations of \$80,000 to \$100,000.

Source: Edward J. Kane, *The S&L Insurance Mess: How Did It Happen?* (Washington, DC: Urban Institute Press, 1989), Table 3-7, p.88.

an additional \$300 million before its closing.³⁶

Effects on the Industry. The activities of insolvent S&Ls had deleterious effects on the entire industry. Because of the perverse incentives created by federal deposit insurance, funds moved from the healthy to the unhealthy, making the entire financial system less safe and less stable. Because they offered above-market rates of interest for deposits, insolvent S&Ls bid up the cost of borrowing for all S&Ls.³⁷ Because they were willing to make mortgage loans for a lower rate of interest (for a given risk class of borrower), insolvent S&Ls lowered the rate on mortgage loans for all S&Ls. As a result, the return on capital was lowered for the entire industry. As Table IX shows, the interest rate spread (between borrowing and lending costs) on new home mortgages in 1987 was one-sixteenth of its 1980 level.

The Role of Government Regulators. The financial health of the S&L industry steadily deteriorated over the last two decades. Potential claims against the insurance agency (FSLIC) have exceeded the agency's reserves at least since 1971. Why didn't government do something?

The problem certainly was not lack of knowledge. Both the regulators and the oversight committees in Congress knew about the problem for years. As early as 1983, an FDIC report warned about it.³⁸ Many healthy thrifts were outspoken critics of the practices of insolvent thrifts —

TABLE VII

Choices for Savers in Texas in 1988¹

(Options Backed by the Full Faith and Credit of the Federal Government)

<u>Type of S&L</u>	<u>Interest Paid on Deposits</u>
Very Insolvent ²	8.28%
Insolvent ³	7.73%
Under-Capitalized ⁴	7.50%
Solvent ⁵	7.29%
Thrifts Outside of Texas	6.96%

¹First quarter 1988.

²Average capital ratio equals -50.3 percent.

³Average capital ratio equals -5.5 percent.

⁴Average capital ratio equals 2.5 percent.

⁵Average capital ratio equals 8 percent.

Source: Eugenie D. Short and Jeffrey W. Gunther, *The Texas Thrift Situation: Implications for the Texas Financial Industry*, Federal Reserve Bank of Dallas, September 1988, Table 5, p. 7.

TABLE VIII

Responses to Incentives: Solvent vs. Insolvent Thrifts in Texas in 1984

<u>Activity</u>	<u>Solvent Thrifts</u>	<u>Insolvent Thrifts</u>
Interest Paid on Deposits ¹	10.6%	10.9%
Interest Charged on Loans ²	11.5%	12.3%
Annual Growth of Assets ³	23.0%	39.0%

¹Average of annualized rates paid on deposits at individual institutions in the fourth quarter of 1984.

²Average of annualized rates earned on mortgage loans and contracts and at individual institutions in the fourth quarter of 1984.

³Average of annualized growth in assets at individual institutions from the fourth quarter of 1980 to the fourth quarter of 1984.

Source: Eugenie D. Short and Jeffrey W. Gunther, *The Texas Thrift Situation: Implications for the Texas Financial Industry*, Federal Reserve Bank of Dallas, September 1988, Table 3, p. 3.

and with good reason. Industry deposit insurance premiums paid to the FSLIC were about \$1 billion per year, although industry net profit was only \$7 billion per year.³⁹

Nor was the failure to act due to a lack of regulatory power. The FSLIC had the power to issue cease-and-desist orders and close down insolvent institutions. If these powers proved insufficient, it could have asked Congress for additional authority. The FSLIC was deterred from closing insolvent institutions by lack of money to pay off depositors when its insurance fund was depleted. Yet it could have gone to Congress for more money.

Not only did government fail to act prudently, it also acted to cover up the problem and make it worse. Creative accounting by the FDIC and FSLIC minimized and concealed the true magnitude of the crisis.⁴⁰ Far from restraining the activities of insolvent thrifts, the regulators on some occasions actually encouraged more reckless behavior.⁴¹ When an increasing number of thrifts failed to meet even the FSLIC's lax capital standards, the agency loosened those standards through a policy of "forbearance" with the full approval of Congress and the Administration.

One influence on the behavior of government officials was undoubtedly the S&L industry lobby. It is well known that the industry contributed liberally to the campaigns of key members of Congress,⁴² and there were numerous instances of congressional pressure put on the regulators.⁴³ Homebuilders, Realtors and their numerous influential supporters also resisted changes that might have reduced the flow of funds through S&Ls to home buyers. But another part of the explanation is that regulatory agencies (and the politicians they answer to) do not like to admit failure. Edward

Kane has argued that the regulators found it in their self-interest to gamble along with the insolvent thrifts. Rolling the financial dice was preferable to a public confession that the system had failed.⁴⁴

How Other Government Policies Have Made Things Worse

Federal deposit insurance does not exist in a regulatory vacuum. In fact, its very existence necessitates further government regulation to counteract the perverse incentive it provides. Because the insurance is underpriced, banks have an incentive to compete more aggressively for funds by bidding up the rate of interest paid to depositors.

TABLE IX

How the Activities of Insolvent Thrifts Affected the Profits Of the Entire S&L Industry

Date	Net Earnings on New Home Mortgages ¹
1980	2.60%
1981	2.61%
1982	2.51%
1983	1.36%
1984	.88%
1985	.69%
1986	.36%
1987	.45%

¹Expressed as a difference between interest rates: Effective interest rate paid on conventional loans on new homes minus the interest rate paid to depositors, with an adjustment for operating expenses.

Source: Edward J. Kane, *The S&L Insurance Mess: How Did It Happen?* (Washington, DC: Urban Institute Press, 1989), Table 1-2, p. 13.

Because subsidized deposit insurance allows banks potentially to earn above-normal profits, new entrants are attracted to the banking industry. Because deposit insurance premiums are unrelated to risks, banks have an incentive to hold more risky portfolios and to over-leverage their capital base.

To keep banking institutions from acting on these incentives, the federal government (and in some cases state governments) imposed numerous restrictions on the activities of banks. These included limits on interest rates paid to depositors, restrictions on entry into the banking market, restrictions on banking institutions' portfolios and regulations governing capital-to-asset ratios. In many cases, however, these regulations have caused further instability.⁴⁵ The combination of state and federal regulations deprived banks and S&Ls of the most fundamental tools of financial risk management, especially diversification in assets, liabilities and geographical markets.

Restrictions on Market Entry. The American banking system is the most decentralized and fragmented in the world. For most of our history, it has been modeled on the idea that each town and locality should be served by one or a few banks that would be shielded from competition to some degree. This model has been enforced by state and federal laws that segment markets and prevent freedom of entry.⁴⁶ The result is a system of many small banks with poorly diversified loan portfolios. A bank which accepts deposits and makes loans in a small geographical area is highly vulnerable to local economic swings, often caused by the economic fortunes of a single industry.⁴⁷ Consider that:

- In the 1920s and 1930s, more than 9,000 banks were closed.

- Yet only 10 of these banks had more than two branches outside their home city.

It is interesting to compare the experience of the U.S. banking system with that of Canada, which has no branch banking restrictions and is dominated by large banks operating nationwide.⁴⁸

- During the Great Depression, both the U.S. and Canada experienced similar monetary shocks.

- Yet not a single Canadian bank failed while one-third of all U.S. banks did.

Restrictions on Investment Portfolios. Just as government has attempted to restrict financial institutions from competing across geographical boundaries, government regulations have segmented the markets in which these institutions can make loans. For many years, S&Ls primarily were restricted to making long-term loans on home mortgages, even though their funds came from the short-term commitments of depositors. Long-term loans had to be made at fixed rates of interest, although the rate paid to depositors could vary. This situation made S&Ls highly vulnerable to declines in local real estate values or increases in interest rates.⁴⁹

Restrictions on Products and Prices. From the 1930s until recently, the federal government severely restricted the kinds of accounts financial institutions could offer customers and the rates of interest they could pay on those accounts. For example, banks were not allowed to pay interest on checking accounts and could pay only a limited rate of interest on savings accounts. S&Ls could not offer checking accounts.

Regulations such as these penalize depositors. They narrow the range of choices open to the banking public and limit the available rate of return, regardless of the choice that is made. They

were enforceable so long as the size of the penalty was small and the ability to circumvent the regulations was limited. However, the high rate of inflation of the 1970s, a revolution in telecommunications and basic human ingenuity have radically changed the environment for financial institutions. Today, banking consumers have numerous ways of avoiding institutions which participate in the federal deposit insurance system and the onerous regulations that accompany that system:⁵⁰

- In 1987, the amount of “money” in money market mutual funds, repurchase agreements and Eurodollars totalled \$1.6 trillion.

- That equaled 57 percent of the \$2.8 trillion held in checking accounts and savings accounts at commercial banks and thrift institutions.

- Put another way, more than one-third of the nation’s (M2) money supply operates outside of the federal deposit insurance system.

Capital/Asset Regulations. Because of federal deposit insurance, depositors today (even large depositors) have no incentive to monitor the financial health of the institutions that hold their deposits. That leaves to federal regulators the task of monitoring nearly 15,000 commercial banks, 3,000 savings and loans and about 400 mutual savings banks — under the best of circumstances, a Herculean task. Moreover, in today’s highly competitive financial markets, the fine tuning of regulatory decisions is increasingly important. If regulators require an institution to hold too much (equity) capital, it will be at a competitive disadvantage. If they require too little capital, the institution will be encouraged to take on too much risk. To make matters worse, the hypothetical “right amount” of capital relative to assets differs for every bank, depending on the composition of its

deposits and its investment portfolio.⁵¹ The market provides a far better guide to how much capital is enough than any government agency could.

Effects of Deregulation. As a result of 1982 financial deregulation (the Garn-St. Germain Act), commercial banks and savings and loan associations gained greater freedom to compete in the financial marketplace. For example, S&Ls were allowed to make nonresidential real estate loans, commercial loans, personal property loans and commercial-type investments. S&Ls could offer almost any type of deposit account (e.g., personal and corporate checking accounts) that commercial banks could offer.

Some have blamed this deregulation for the banking crisis in general and the S&L crisis in particular. Yet this criticism is misdirected. As noted above, the S&L industry was already in serious trouble before deregulation. Moreover, deregulation affected healthy and unhealthy institutions in different ways. It gave insolvent institutions more opportunities to throw Hail Mary passes. However, these institutions were only being kept alive in the first place by federal deposit insurance. For healthy institutions, deregulation was a long-term necessity. Without it, many could not have survived the competition in the financial marketplace. For example, although it is not generally appreciated, commercial banks have been losing market share for decades:⁵²

- In 1945, commercial banks held 65 percent of all U.S. financial assets held by financial intermediaries.

- By 1985, the market share of banks had declined to 30 percent.

In general, deregulation contributed to instability only because it was partial rather than com-

plete. It gave some institutions the necessary freedom to compete, while leaving others with even more perverse incentives — precisely because it left the federal deposit insurance system intact.⁵³

The Special Regulatory Treatment Given to Savings and Loans. One reason for the current crisis in the S&L industry may be that (more so than other financial institutions) this industry has been shaped and molded by government policy. In fact, some economists have argued that but for government, the S&L industry would not exist.⁵⁴ Among the special privileges the federal government has granted the industry are the following:⁵⁵

- Prior to 1951, S&Ls were exempt from income taxes and, although this exemption has been eroded considerably since that time, S&Ls still enjoy a tax advantage over commercial banks.

- Although commercial banks faced interest rate ceilings on deposits, S&Ls had no ceilings prior to 1966, and although a ceiling did exist between 1966 and 1984, it was higher than the rate for banks.

- While maintaining a preferential interest rate on deposits, S&Ls were gradually allowed to compete with banks in the market for loans. In the 1960s, S&Ls acquired the right to make loans on mobile homes, vacation homes and housing fixtures, as well as some unsecured personal loans; in 1982, they acquired the right to make loans nationwide.

These special regulatory advantages paid off. While the commercial banks' market share dropped from 65 to 30 percent from 1945 to 1985, the S&Ls' market share climbed from 3 percent to 16 percent.⁵⁶ However, not all of the increase in

market share for S&Ls from 1945 to 1985 should be attributed to their special regulatory advantages. The homebuilding boom from World War II through the early 1960s greatly increased demand for mortgage loans. S&Ls met the demand. Commercial bankers, with few exceptions, thought mortgage lending was not well suited to their style and skills, so they let the early opportunity pass.

Because long-term interest rates were higher than short-term rates between 1945 and 1965, mortgage lending was a profitable, apparently safe business. By the time commercial bankers ventured into home mortgage lending later in the 1960s, the increasing volatility of short-term interest rates had made funding long-term fixed-rate mortgages with short-term deposits a much more risky business. Nevertheless, Congress and the regulators, responding to pressure from homebuilders and from S&Ls, tried for a long time to increase the supply of mortgage funds by conferring regulatory advantages on S&Ls.

New Incentives to Escape the Deposit Insurance System. Any insurance system in which premiums are not tied to risk penalizes firms which are prudent and financially healthy. As insolvent or financially unhealthy firms react to the perverse incentives of deposit insurance, the premiums charged to all must rise to cover the cost of the bailouts. These higher premiums give the financially healthy firms an even greater incentive to leave the system. For example, after the FSLIC increased its premium to S&Ls, many financially healthy thrifts attempted to become "banks" and join the FDIC. The government reacted by imposing a hefty tax on those escaping the system and then by banning such moves.

A far more serious problem for U.S. banks and S&Ls is that they must compete with money mar-

ket mutual funds and large “nonbank” financial institutions in this country and abroad. These other institutions do not have to pay for deposit insurance, hold non-interest bearing deposits at Federal Reserve Banks (required reserves) or submit to detailed, costly supervision from bank regulators. Yet they can do almost anything that banks can do and in some areas, more. The costs of deposit insurance premiums and the associated supervisory requirements are a growing handicap for U.S. banks and S&Ls in the world financial services marketplace.

In the modern era, capital travels around the world on an electronic highway at the speed of light. It will not remain long where it is unfairly “taxed” or unduly burdened by regulation. Unless federal policymakers come to grips with the inherent defects of federal deposit insurance and other financial regulations, more and more capital will leave the system.

Can Any Form of Federal Deposit Insurance Work?

Probably not. With the exception of the current FDIC system (and the NCUSIF), every deposit insurance scheme tried in this country has come unraveled — and the principal cause of failure is common to all. In this section, we briefly summarize America’s experience with deposit insurance and the difficulties any system of deposit insurance (even the most ideally designed) would face. Then we examine the question of whether deposit insurance is really necessary.

Our Historical Experience With Deposit Insurance⁵⁷

The recent demise of the FSLIC because of the

savings and loan crisis is not a unique experience. There have been numerous experiments with deposit insurance at the state level — in the 19th century, early in the 20th century and in more recent times.⁵⁸ All of these insurance schemes failed, and in each case the pattern was the same. Initially banks were charged a fixed premium, independent of the riskiness of their portfolios. What followed were bank failures due to “reckless” banking practices. To cover their losses, the insuring agencies raised premiums and often borrowed money. As the premiums soared, sound banks fled the system, leaving it even more risky and unstable. Eventually the agency’s funds were exhausted and it collapsed, often without reimbursing depositors for their losses.

The 19th-Century Experience. The first state deposit insurance scheme was created in New York in 1829. By 1842, the fund was exhausted by the failure of “insured banks.” In each case, the banks failed because of “recklessness,” including “insider dealing.”⁵⁹ State funds were also created in Vermont in 1831 and in Michigan in 1836. Both funds ended with experiences similar to New York’s.

The Early 20th-Century Experience. From 1908 to 1917, deposit insurance systems called guaranty funds were established in Kansas, Mississippi, Nebraska, North Dakota, Oklahoma, South Dakota, Texas and Washington. All failed during the (prosperous) 1920s. Moreover, evidence suggests that these funds made banking less stable in the states that had them.⁶⁰

■ Other things equal, state banks in states with guaranty funds failed at a higher rate than state banks elsewhere.

■ On the average, the existence of a guaranty fund

raised the failure rate of deposits by 1.9 percentage points.

Recent Experience. During the 1980s, the failures of state deposit insurance systems for savings and loan associations in Maryland, Nebraska and Ohio were widely publicized. In all three cases criminal fraud was involved in the collapse of a major S&L, the failure of which caused the collapse of the entire system. In Maryland and Nebraska the presidents of the S&Ls involved went to prison.

Inherent Problems with Deposit Insurance

Our experience with the FDIC and FSLIC at the federal level and with numerous deposit insurance systems at the state level teaches valuable lessons about the whole process of insuring deposits at financial institutions.

- 1. No deposit insurance system is likely to succeed unless premiums reflect risks.** When premiums for individual institutions do not reflect the riskiness of the institution's portfolio, the perverse incentives are so strong that eventually they overwhelm the system.
- 2. No deposit insurance system is likely to succeed if government is a monopoly insurer.** Regulatory bureaucrats, who have no financial stake in their decisions, can have incentives that are every bit as perverse as the incentives of the insured institutions. As we saw in the case of S&Ls, the regulators (and even Congress and the Administration) were willing to go with the throw of the financial dice by the managers of insolvent thrifts.

- 3. No deposit insurance system is likely to succeed unless bank depositors have a financial incentive to monitor banks.** It is inconceivable that a single agency can monitor the complex banking system as well as an entire marketplace in which numerous individuals have a financial self-interest.

- 4. Even if the deposit insurance system is ideally designed, it still may not work.** In the complicated world of banking, there are numerous ways in which bank managers can take on risk.⁶¹ Many types of risky behavior are extremely difficult to monitor and, unlike many other kinds of insurance, bank managers have enormous ability to affect the outcome through their own choices. As Gerald O'Driscoll has argued, there is no once-and-for-all answer to the question, "What premium should be assessed?"⁶² And if a market for insurance produces an answer, it may vary from day to day like prices on the stock market. It is worth noting that bankruptcy insurance does not exist in any other industry, and private bankruptcy insurance has never existed in banking. This may explain the comments of William Seidman, chairman of the FDIC:⁶³

"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."

Is Deposit Insurance Necessary?

Is there a social reason why government should either provide or mandate deposit insurance? Historically, federal deposit insurance has appeared to be socially important for two reasons. First, during

the 1930s deposit insurance was thought to promote economic stability because it was widely believed that bank runs and bank failures were linked with economic depressions. Second, deposit insurance was considered a relatively inexpensive way to provide small savers with a degree of safety lacking in the private markets. Today, neither argument is persuasive.

Preventing Depressions. We now know that there is no necessary connection between bank failure and economic depression. Between 1921 and 1928, one-sixth of all U.S. banks failed. Yet this was a period of general prosperity and price stability.⁶⁴ As noted above, during Canada's Great Depression, not a single Canadian bank failed. Moreover, the knowledge of how to prevent a depression has been available for more than a century.⁶⁵

If people pull their deposits out of a bank because they are worried about the quality of management, they are most likely to transfer those deposits to other banks. Total deposits of the banking system remain unchanged, and stability of the economy is not threatened. In the unlikely case that the nervous customers of a suspect bank hide their currency in mattresses at home, the Federal Reserve can easily maintain liquidity in the banking system by supplying additional reserves through open market purchases of securities or lending through the discount window. That is what the Federal Reserve Banks were created to do — but did not do — during the crash of 1930-33.

Failures of individual banks, even large ones, do not leave irreparable holes in the fabric of the banking system. Failures are of course painful to bank stockholders and managers, but bearing that risk is the essential function of stockholders. Managers, too, have their careers on the line.

Moreover, an occasional bank failure is instructive for the managers of other banks.

Protecting Depositors. Modern technology has made it possible for the small saver to acquire the full faith and credit of the federal government through “checking accounts” directly backed by U.S. government securities. Money market mutual funds and other “nonbank banks” offer this safety and security to depositors without the necessity of deposit insurance.⁶⁶ Deposit insurance, far from being socially necessary, is instead a private good which may be of value to some people but not to others.

Conclusion: Living without Deposit Insurance

Deposit insurance has been used for years as a substitute for market discipline in maintaining a safe, sound, efficient financial system. It has not worked. The costs of federal deposit insurance are simply too large for taxpayers to accept much longer, as the S&L bailout has demonstrated. Bankers, who might appear to be the main beneficiaries of the system, cannot afford it either — although many do not realize it yet.

If legislators and regulators try to plug the loopholes in the deposit insurance system in order to keep it going, they will exact a heavy price from U.S. bank customers, depositors and stockholders. They are certain to raise federal deposit insurance premiums and to mandate higher, more complicated capital requirements for banks. Even worse, the regulators will be more diligent — read oppressive — in supervising banks' lending, investing and borrowing policies. Having been accused of negligence in overseeing the conduct of S&Ls, supervisors already are showing signs of overkill

in dealing with commercial banks.

All of these additional costs will seriously handicap U.S. banks in competing with nonbank financial institutions at home and abroad and with the banks of other countries. Their share in world financial markets will continue to decline.

Now is the time to begin phasing out federal deposit insurance rather than trying to preserve it with more regulations and bureaucratic interventions. Specifically we should do the following:

- 1. Phase Out the Existing System of Deposit Insurance.** We should begin immediately — first by limiting the amount of any deposit covered by insurance and then by gradually reducing the percent of deposits covered by insurance. For example, coverage might be reduced to 100 percent of deposits up to \$40,000 in 1992; 80 percent of deposits up to \$40,000 in 1993; 60 percent of deposits in 1994, etc. By 1997, coverage would be completely eliminated.
- 2. Expand the Ability of Bank Consumers to Have Direct Access to the Full Faith and Credit of the Federal Government.** Laws and regulations should be clarified so that the most risk-averse people could open accounts backed directly by government securities. In case of bankruptcy on the part of the bank managing the accounts, the securities would be the property of the account holders — not of the bank. The interest rate paid to depositors would be the rate of interest paid on government securities minus the bank's charge for holding and servicing the account.

- 3. Expand the Ability of Consumers to Make Choices Among Accounts With Different Combinations of Risk and Return.** Laws and regulations should be clarified and simplified so that bank customers could open deposits backed directly by corporate bonds, stocks, real estate and other assets. For example, those willing to take some risk in return for a higher expected rate of return might have an account backed directly by high-grade corporate bonds. For an even higher expected rate of return (and more risk), the account might be backed by a portfolio of real estate investments. Conventional bank accounts would also continue to be an option. The exact nature of the portfolio-backing accounts would be determined by competition in the marketplace.
- 4. Through Appropriate Deregulation, Banks and S&Ls Should be Allowed Maximum Flexibility to Satisfy Consumer Wants and Needs.** In order to maximize consumer satisfaction at minimum costs, financial institutions should be free to make their own decisions with respect to the rates paid for deposits, investment portfolios and the geographical areas in which deposits are accepted and investments are made.
- 5. Taxpayers Should Face No Risk and Depositors Should Face Only Voluntarily Chosen Risks With Respect to Bank Failures.** In a new, competitive banking system, operating on the principles outlined above, taxpayers would not be at risk for any bank failure. Depositors would be at risk for bank failures only if they chose to be.

NOTE: Nothing written here should be construed as necessarily reflecting the views of the National Center for Policy Analysis or as an attempt to aid or hinder the passage of any bill before Congress.

Footnotes

- ¹Bank deposit figures from Federal Reserve System monetary statistics. S&L deposits from the Office of Thrift Supervision.
- ²George G. Kaufman, "Lender of Last Resort, Too Large to Fail and Deposit Insurance Reform." Paper prepared for the Conference on Reform of Deposit Insurance and the Regulation of Depository Institutions in the 1990s: Setting the Agenda, sponsored by the Center for Economic Policy Research, Stanford University, Washington, DC, May 18-19, 1990.
- ³Deposit Insurance Reform Committee of the American Bankers Association, "Federal Deposit Insurance: A Program for Reform," ABA, Washington, DC, March 1990, p. 7.
- ⁴James B. Barth and R. Dan Brumbaugh, Jr., "The Rough Road from FIRREA to Deposit Insurance Reform," *Stanford Law and Policy Review*, Vol. 2, No.1, Spring 1990, p. 61.
- ⁵Carol A. Leisenring, "The Savings and Loan and FSLIC Bailout: What Are You Getting for Your Tax Money?," *CoreStates Comments*, Fall 1989.
- ⁶Donald G. Simonson and George H. Hempel, "Running on Empty: Accounting Strategies to Clarify Capital Values," *Stanford Law and Policy Review*, Vol. 2, No. 1, Spring 1990, pp. 92-101.
- ⁷See G. Christian Hill, "A Never Ending Story: An Introduction to the S&L Symposium," *Stanford Law and Policy Review*, Vol. 2, No. 1, Spring 1990, p. 23.
- ⁸Edward J. Kane, "The Political Foundations of the Thrift Debacle: The Incentive Incompatibility of Government-Sponsored Deposit Insurance Funds." Paper prepared for the Conference on Reform of Deposit Insurance and the Regulation of Depository Institutions in the 1990s.
- ⁹"RTC Chief Totals Growing Expenses of Thrift Bailout," *Wall Street Journal*, September 20, 1990.
- ¹⁰Ironically, the Federal Reserve System's managers were attempting to hold interest rates down through monetary expansion.
- ¹¹See also George J. Benston and George G. Kaufman, "Understanding the Savings and Loan Debacle," *The Public Interest*, Spring 1990, p. 83.
- ¹²The Tax Reform Act of 1986 reduced the highest personal tax rate by 44 percent, thus reducing the appeal of real estate to investors. It effectively eliminated real estate as a tax shelter, and it eliminated the use of Industrial Revenue Bonds as a vehicle for financing real estate development. According to one analyst, this led to the pervasive dumping of \$500 billion worth of real estate onto the market. See William B. Michaels, "A Different Savings and Loan Villain," *New York Times*, July 8, 1990.
- ¹³See, for example, R. Dan Brumbaugh, Jr. and Robert E. Litan, "A Critique of the Financial Institutions Recovery, Reform and Enforcement Act (FIRREA) of 1989 and the Financial Strength of the Commercial Banks." Paper prepared for the Conference on Reform of Deposit Insurance and the Regulation of Depository Institutions in the 1990s.
- ¹⁴For a chronology of FIRREA's progress through the legislative process, see Brumbaugh and Litan, "A Critique of the Financial Institutions Recovery, Reform and Enforcement Act of 1989 and the Financial Strength of Commercial Banks." Paper prepared for the conference on the Reform of Deposit Insurance and the Regulation of Depository Institutions in the 1990s.
- ¹⁵Edward J. Kane, "FIRREA: Financial Malpractice," *Durrell Journal of Money and Banking*, Vol. II, No. 2 (May 1990), p. 7.
- ¹⁶See Hill, "A Never Ending Story," p. 14, and Barth and Brumbaugh, "The Rough Road from FIRREA to Deposit Insurance Reform," p. 63.
- ¹⁷See Eugenie D. Short, "FIRREA: Texas and the Nation," *Durrell Journal of Money and Banking*, Vol. II, No. 2 (May 1990), pp. 15-18, for discussion of the study proposals.
- ¹⁸See Thomas Romer and Barry R. Weingast, "Political Foundations of the Thrift Debacle." Paper prepared for an NBER conference in Cambridge, MA, May 14-15, 1990, and the Conference on Reform of Deposit Insurance and The Regulation of Depository Institutions in the 1990s.
- ¹⁹Benston and Kaufman, "Understanding the Savings and Loan Debacle," p. 91. The literature on deposit insurance is mushrooming. The Federal Deposit Insurance Corporation refers to much of this research in its own studies. See, for example, FDIC, *Deposit Insurance in a Changing Environment* (Washington, DC, 1983), and FDIC, *Mandate for Change: Restructuring the Banking Industry* (Washington, DC, 1987).
- ²⁰The Treasury's ideas on deposit insurance reform may appear sooner than 1991. Robert R. Glauber, Under Secretary for Finance, U.S. Treasury, told an American Enterprise Institute Conference on International Competitiveness in Financial Services, May 31, 1990, that the Treasury committee hopes to have its report out by the end of 1990.
- ²¹Charles E. Schumer and J. Brian Graham, "The Unfinished Business of FIRREA," *Stanford Law and Policy Review*, Vol. 2, No. 1, Spring 1990, p. 72.
- ²²Brumbaugh and Litan, "A Critique of the Financial Institutions Recovery, Reform and Enforcement Act (FIRREA) of 1989 and the Financial Strength of the Commercial Banks."
- ²³See "Federal Deposit Insurance: A Program for Reform," American Bankers Association, Washington, DC, March 1990.
- ²⁴Robert E. Litan. Quoted in Sarah Bartlett, "Would the Savings Industry Do Better Without Help?," *New York Times*, February 26, 1989.
- ²⁵Robert E. Litan, "The American Banking System: Dangers and Tasks Ahead," in Susan Irving, ed., *Economic Vulnerabilities: Challenges for Policymakers*, (Washington, DC: Curry Foundation,) p. 45.
- ²⁶Through 1984 the annual premium for both FDIC and FSLIC was 1/12 of 1 percent of an institution's deposits. In 1985 an additional surcharge of 1/8 of 1 percent was added for FSLIC member institutions. Part of the FDIC premium was rebatable — returned to the banks if the premium consequently turned out to be higher than necessary. FSLIC premiums were not rebatable. See Edward J. Kane, *The Gathering Crisis in Federal*

Deposit Insurance (Cambridge: MIT Press, 1985), pp. 67-72. Under the Financial Institutions Reform, Recovery and Enforcement Act of 1989, premiums for both S&L and bank deposit insurance will increase.

²⁷In 1982, Congress passed a joint resolution putting the full faith and credit of the U.S. Treasury behind the guarantees of the federal deposit insurance agencies. This promise was reaffirmed in the Competitive Equality Banking Act of 1987 (CEBA).

²⁸See Eugenie D. Short, "FDIC Settlement Practices and the Size of Failed Banks," *Economic Review*, Federal Reserve Bank of Dallas, March 1985, pp. 12-20. The FDIC has acknowledged that its activities create de facto insurance for large depositors at large institutions. See *Deposit Insurance in a Changing Environment: A Study of the Current System of Deposit Insurance Pursuant to Section 712 of the Garn-St. Germain Depository Institutions Act of 1982, submitted to the United States Congress by the Federal Deposit Insurance Corporation* (Washington, DC: Federal Deposit Insurance Corporation, 1983), p.1.

²⁹In 1984, C. Todd Conover, Comptroller of the Currency, testified that the federal government would not allow the nation's largest banks to fail. See Tim Carrigan, "U.S. Won't Let 11 Biggest Banks in the Nation Fail," *Wall Street Journal*, September 20, 1984.

³⁰This conclusion has been rigorously demonstrated in a number of papers. See William F. Sharpe, "Bank Capital Adequacy, Deposit Insurance and Security Value," *Journal of Finance and Quantitative Analysis*, November 1978, pp. 701-718; Michael Koehn and Anthony M. Santomero, "Regulation of Bank Capital and Portfolio Risk," *Journal of Finance*, December 1980, pp. 1235-1244; and Mark J. Flannery, "Deposit Insurance Creates a Need for Bank Regulation," *Business Review*, Federal Reserve Bank of Philadelphia, January/February 1982, pp. 17-27. For an explanation of how federal deposit insurance combined with other forms of regulation affects managerial decisions, see Roger W. Garrison, Eugenie D. Short and Gerald P. O'Driscoll, Jr., "Financial Stability and FDIC Insurance," *The Financial Services Revolution*, pp. 187-207.

³¹Edward J. Kane, *The S&L Insurance Mess: How Did It Happen?* (Washington, DC: Urban Institute Press, 1989), p. 4.

³²Comptroller of the Currency, *Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks*, June 1989. Cited in Litan, "The American Banking System: Dangers and Tasks Ahead," p. 53.

³³Clifford F. Thies and Daniel A. Gerlowski, "Deposit Insurance: A History of Failure," *Cato Journal*, Vol. 8, No. 3 (Winter 1989), p. 690. More recently, an investigation by the FDIC concluded that criminal fraud and abuse were present at almost half of the insolvent S&Ls it examined. See Nathaniel C. Nash, "FDIC Found Fraud at Half of Savings Units it Studied," *New York Times*, May 19, 1989.

³⁴Thies and Gerlowski, "Deposit Insurance," p. 690.

³⁵See Lee Hancock, "Ex-Loan Commissioner Allegedly Got S&L Perks," *Dallas Morning News*, August 5, 1989.

³⁶Thies and Gerlowski, "Deposit Insurance," p. 690.

³⁷For an analysis of how insolvent thrifts have affected the rate of interest on deposits paid by all thrifts in Texas, see Eugenie D. Short and Jeffrey W. Gunther, "The New Financial Landscape in Texas: Policy Implications of the Southwest Plan," *The Bankers Magazine*, March/April 1989, pp. 15-21; and Short and Gunther, *The Texas Thrift Solution: Implications for the Texas Financial Industry*, Federal Reserve Bank of Dallas, September 1988.

³⁸See *Deposit Insurance in a Changing Environment*, p. xiii.

³⁹Lowell L. Bryan, "Who Pays for the Mess?," *Wall Street Journal*, November 18, 1988.

⁴⁰For an explanation of agency accounting, see Kane, *The S&L Insurance Mess*, ch. 2.

⁴¹*Ibid.*, p.7.

⁴²Kane, *The S&L Insurance Mess*.

⁴³In one of the most highly publicized cases, the closure of Lincoln Savings & Loan of Irvine, California, was delayed by the intervention of five U.S. Senators who had received a total of \$329,000 in campaign contributions from Lincoln's owners and managers. See Warren Brookes, "Politics and Banking: Unholy Alliance?," *Washington Times*, June 16, 1989. For an analysis of how congressional criticism encourages regulators to keep insolvent S&Ls open, see Robert H. Bartel, Jr., "An Analysis of Illinois Savings and Loan Associations Which Failed in the Period 1963-68," in Irwin Friend, ed., *Study of the Savings and Loan Industry*, prepared for the Federal Home Loan Bank Board, Washington, DC, Vol. 1, 1969, pp. 345-436.

⁴⁴Kane, *The S&L Insurance Mess*, ch. 5.

⁴⁵For an explanation of the relationship of these restrictions to the incentives created by deposit insurance, see Garrison, Short and O'Driscoll, "Financial Stability and FDIC Insurance," pp. 193-195.

⁴⁶Laws against branch banking were enacted by state governments, and federal law required federally chartered banks to abide by these restrictions. For federally chartered S&Ls, however, the restrictions were imposed by Washington. Federal S&Ls were initially required to limit their lending to home mortgages secured by houses within 50 miles of the S&L's home office. In 1964, the radius was extended to 100 miles. See Barth and Regalia, "The Evolving Role of Regulation in the Savings and Loan Industry," p. 132.

⁴⁷George J. Benston, "Deposit Insurance and Bank Failures," *Economic Review*, Federal Reserve Bank of Atlanta, March 1983, p.10.

⁴⁸Gerald P. O'Driscoll, "Deposit Insurance in Theory and Practice," *The Financial Services Revolution*, pp. 166-175.

⁴⁹For a more detailed analysis of the vulnerability of S&Ls to volatile changes in market rates of interest, see Kane, *The S&L Insurance Mess*, pp. 72-75.

⁵⁰Thies and Gerlowski, "Deposit Insurance," p. 692.

⁵¹Benston, "Deposit Insurance and Bank Failures," p. 14.

⁵²Barth and Regalia, "The Evolving Role of Regulation in the Savings and Loan Industry," p. 114.

⁵³See the discussion in Garrison, Short and O'Driscoll, "Financial Stability and FDIC Insurance," pp. 195-206.

⁵⁴According to banking economist David Fand, “The thrift is a bastardized creation of government, a kind of financial Mongoloid because it was specifically designed to borrow short and lend long. That worked in a stable interest rate environment, but today it has become an anachronism.” Quoted in Warren Brookes, “Should There Be a Thrift Industry?”, *Detroit News*, March 13, 1989.

⁵⁵For a history of the evolution of government regulation of the S&L industry, see Barth and Regalia, “The Evolving Role of Regulation in the Savings and Loan Industry,” pp. 113-161.

⁵⁶*Ibid.*, p. 114.

⁵⁷This section is based on Thies and Gerlowski, “Deposit Insurance,” pp. 677-693.

⁵⁸The actual history of these early experiments differs considerably from the “official history” published by the FDIC. *Ibid.*, p. 680.

⁵⁹Interestingly, the banks which grew to make New York City a financial center were “free banks” which did not participate in the insurance scheme. *Ibid.*, p. 680.

⁶⁰*Ibid.*, p. 688.

⁶¹See the discussion in Kane, *The Gathering Crisis in Federal Deposit Insurance*, pp. 62 ff.

⁶²O’Driscoll, “Deposit Insurance in Theory and Practice,” p. 170.

⁶³Quoted in Thies and Gerlowski, “Deposit Insurance,” p. 677.

⁶⁴Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867-1960*, (Princeton, NJ: Princeton University Press for the National Bureau of Economic Research, 1963), pp. 438-39.

⁶⁵Anna J. Schwartz, “The Lender of Last Resort and the Federal Safety Net.” Paper presented at the Symposium on Monetary Economics in Memory of Michael J. Hamburger, March 12, 1987. Salomon Brothers Center for the Study of Financial Institutions, New York University, Graduate School of Business Administration, p. 21.

⁶⁶For a general discussion of nonbank banks, see Catherine England, “Nonbank Banks Are Not the Problem: Outmoded Regulations Are,” in *The Financial Services Revolution*, pp. 251-265.

About the Authors

A. James Meigs, retired senior vice president and chief economist of First Interstate Bancorp and Senior Fellow of the NCPA, is an independent scholar and economic consultant. He is a member of the American Participant Program of the United States Information Agency, is on the Board of Trustees of the Foundation for Research on Economics and the Environment, and is a Fellow of the National Association of Business Economists. Before joining First Interstate Dr. Meigs was an economist for the Federal Reserve Bank of St. Louis, the New York Stock Exchange, Citibank, Argus Research Corporation, and Oppenheimer and Co., Inc. He was professor of economics for five years at Claremont McKenna College. He was a director of Capstone EquityGuard Stock Fund, Inc. from 1986-1990.

Dr. Meigs has a B.A. from Harvard and a Ph.D. from the University of Chicago. He has written many articles and two books, *Free Reserves and the Money Supply* (University of Chicago Press, 1962) and *Money Matters: Economics, Markets, Politics* (Harper & Row, 1972).

John C. Goodman is president of the National Center for Policy Analysis. Dr. Goodman earned his Ph.D. in economics at Columbia University and has engaged in teaching and research at six colleges and universities, including Columbia University, Stanford University, Dartmouth College, Sarah Lawrence College and Southern Methodist University. Dr. Goodman has written widely on health care, Social Security, privatization, the welfare state and other public policy issues. He is author of six books and numerous scholarly articles. His published works include *National Health Care in Great Britain, Regulation of Medical Care: Is the Price Too High?*, *Economics of Public Policy* and *Social Security in the United Kingdom*.