INEQUITIES IN THE DEPOSIT INSURANCE SYSTEM

There always has been some degree of inequity in the deposit insurance treatment of large and small failing banks. Specifically, there has been a tendency to handle large failing banks in a manner that protects uninsured depositors and other general creditors from loss while smaller failing banks are more frequently subject to a statutory payoff, thus uninsured creditors are exposed to loss.

In recent years, the FDIC has occasionally placed a de facto "guarantee" on the liabilities of certain institutions (more accurately, the FDIC has made a commitment to handle the bank(s) in a manner that would not result in losses to general creditors). This action has been taken in situations where there is a perceived threat to the stability of the banking system. This "guarantee" has been limited to three cases: Continental Illinois in 1984; First City and First Republic in 1988.

The FDIC is well aware of the competitive distortions that result from taking an action that permits an institution to issue liabilities "guaranteed" by the U.S. Government. Thus, such action has not been taken lightly.

A variety of suggestions have been made that are designed to ameliorate the distortions associated with an outright guarantee. While each of the suggestions is intended to achieve equity, each also would have some negative impacts. The following is a brief summary of the pros and cons of each proposal.

- Depositor Discipline. The ability of the FDIC to provide more protection than the statutory limit would be restricted. This suggestion would remove inequity between large and small banks. However, it could lead to an unacceptable level of instability in the banking system.

- Raise Insurance Premiums for Large Banks. Premiums would be based on total liabilities that fall in the same creditor class as deposits. This suggestion would bring the insurance cost for large institutions more in line with de facto coverage, thus reducing inequities. However, these added costs may overly restrict large banks' ability to compete in global markets. Larger banks may respond by shifting business to noninsured subsidiaries, thereby reducing premium income.

- Provide 100 Percent Deposit Insurance To All Banks. This would be the most straightforward way of providing all depositors with the same treatment regardless of the size of their bank. The cost to the FDIC fund would be negligible (at least in the short run) because most depositors are already protected. Furthermore, it would be easier to handle failures because there would be no need to compute insured deposits on payoff; an entire deposit base could be transferred easily, leaving behind creditors and contingent claims.

A full insurance approach, however, would completely eliminate depositor discipline and might raise longer-term insurance costs. It also would remove incentives for spreading deposits to smaller banks to maximize insurance coverage.

- Modified 100 Percent Deposit Insurance Coverage. This suggestion would not extend 100% coverage to certain deposits such as negotiable time deposits. Only transaction accounts and consumer and local business-type time deposits would get full coverage.

  Such an approach would reduce big bank/small bank inequity without completely eliminating depositor discipline. It does reduce depositor discipline, and it doesn't eliminate big bank/small bank inequities. Therefore, this suggestion represents only a partial solution.

- Limit Business Activities of Banks Operating Under 100 Percent Guarantee. This approach would require that rates on deposits be kept below market rates; business solicitation (letters of credit, etc.) would be restricted to existing customer base.

  If used, it would minimize damage to bank competitors. However, some customers might still be attracted by the insurance guarantee without added solicitation. Moreover, this suggestion does not resolve the big bank/small bank equity issue.

- Restrict the Full Insurance Guarantee to Existing Deposit Accounts. This suggestion would not permit a bank to use an insurance "guarantee" to attract new business, therefore minimizing damage to bank competitors. However, it would limit the ability of a bank to replace outflows with new deposits. It also would create massive recordkeeping problems for the bank, and for the FDIC if the bank is ultimately paid off. Furthermore, it may lead to market confusion over what is, and what is not, insured. It does not resolve the small bank/large bank equity issue.

- Extend Guarantee to Other Banks in State. Providing a full insurance guarantee to all banks operating in the same state would preserve intrastate equity. However, inequities would remain with respect to out-of-state competitors. Furthermore, banks within the state operating with 100% insurance might raise new supervisory issues.