Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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As night follows day, so proposals to privatize the FDIC have again followed bank failures. While debate over deposit-insurance privatization was, is, and will be an ideological tug of war between free-market conservatives and government safety-net progressives, it's nonetheless an important option that warrants careful analysis as the FDIC yet again faces huge losses, banks are charged crippling and procyclical premiums, and talk turns to still more federal coverage at still greater risk not just to insured banks, but also to taxpayers. Pure FDIC privatization remains impossible, but target risk transfers warrant careful, but quick consideration.

Privatization was last seriously discussed when Congress rewrote FDIC coverage in 2006. This was a halcyon time when the FDIC was so sanguine about all the rules put in place after the S&L and bank crises that its 2007 study confidently predicted that systemic risk was a thing of the past, uninsured deposits would never again be covered, and the Deposit Insurance Fund more than sufficed for any systemic situation.

Of course, the great financial crisis that began later that same year put the lie to all this happy talk. Privatization proposals now aren't anywhere near as happy nor do they repeat past assertions that, with FDIC privatization, the nation could also dispense with bank regulation. Instead, and for good reason, talk has now returned to private options because, without them, moral hazard seems sure to be embedded in a financial system that is still more shadowy.

A modern rethink of FDIC privatization must begin with a modern understanding of financial-market developments since the 2007 study considered privatization only as wholesale transformation of a federal program into a private marketplace. That was and is impossible. As Alan Greenspan said at the time, "banking is subject to systemic risk and is thus subject to a far larger extreme loss in the tail of the probability distributions from which real insurance premiums would have to be calculated." He goes on to make clear that the only way to price premiums even just for insured deposits has to involve a federal subsidy because, without it, no bank could afford its premiums and there thus wouldn't be insured depositories.

The fuss banks are putting up over the special assessment to pay for the SVB and Signature failures shows what a strategically-significant cost even subsidized FDIC premiums have proven to be. Without a subsidy mandated as a substitute for federal coverage, a private scheme is sure to fail at the first sign of systemic hazard or even just the first good-sized failure.

But, does private deposit-insurance coverage have to substitute in its entirety for a federal backstop? Sixteen years after the FDIC said no to privatization, financial markets have become far more expert at structuring financial risk and bringing in private capital in ways never contemplated in the FDIC's study or Mr. Greenspan's remarks.

It's thus more than worth considering if structured credit risk transfers (CRT) could be adapted to absorb at least some FDIC risk. A top-order question about any such CRT is which FDIC risk it takes: that of insured deposits or that the FDIC could absorb in the event of a systemic designation akin to that in March.

It seems to me that expressly-insured deposits should have the benefit of subsidized FDIC insurance conferred by a full-faith-and-credit guarantee because of the vital importance these funds have not just to households and small businesses, but also to a sound financial system. But, as we know all too well, FDIC coverage can be universal in a crisis. As a result, just as we have property-and-casualty insurance for individual losses and catastrophe bonds for calamities, so too could we have FDIC insurance for ordinary bank failures and private-sector risk shares that bear at least some of the risk if the FDIC finds itself forced to break the glass in the face of a wider conflagration.

Private structured risk shares do not have an unsullied history. As a result, a prerequisite of any risk transfer is that the party taking the risk be able to bear it. Many structured risk transfers without essential wherewithal have given this sector a deservedly dubious reputation and taxpayers should not allow private companies to take all the premiums and yet still leave the federal government with most of the loss.

Another prerequisite of deposit-risk transfers is that these should not be taken by other banks given the wrong-way risk this clearly involves. As a result, how much risk could be transferred is necessarily constrained by how much capital there is likely to be in the market willing to take it.

This in turn depends in large part on how much risk is likely to be realized in each transfer under what probabilities. Deposit risk-shares for all but the largest banks are unlikely because the cost of analyzing hundreds of smaller ones is daunting and expensive even if lots of little-bank coverage is pooled into some sort of single financial instrument. While it's possible that a large portfolio of lots of small banks creates enough portfolio diversification to minimize this challenge, market data is most plentiful for larger banks not only because they each release so much more, but also because they issue corporate debt and preferred stock the market understands how to price. Even so, it seems both likely and desirable that supervisors make public key risk indicia about each privately-insured bank.

A private scheme for above-the-line risk at larger banks would have to be mandatory to avoid adverse selection and should be considered another form of total loss-absorption capacity (TLAC). Indeed, maybe private credit enhancement should be added to or even substituted for the long-term debt the banking agencies now depend upon as a GSIB risk buffer and are soon to demand of large regional banks. Fee-based credit risk transfer is more capital efficient for banks than long-term debt and could be at least as much of a buffer ahead of the FDIC and other claimants in a bank collapse.

Privatizing parts of bank deposit risk isn't easy, but failing to consider it guarantees that, each time the FDIC is surprised, systemic declarations will make every depositor whole all over again. Since the FDIC is always surprised by anything but a very small-bank failure, deposit-insurance protection should include an added element of market discipline likely only to come from private counterparties with real skin in this critical game.