Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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Last week's memo stirred up a lot of comment about ways to provide at least some private-sector deposit insurance. The consensus is that, while nothing is easy about a private-sector backstop for federal coverage, the concept warrants careful consideration because all the other reform ideas on their own are still more problematic. This isn't just because proposals for expanded federal coverage – my own included – extend the federal safety net at resulting moral hazard. In some cases, as I said, this risk is worth taking because some depositors warrant protection. Still, there's sure to be a price for more federal coverage – super-costly premiums and/or more bank regulation – that argue for market-based solutions to the greatest extent compatible with social welfare and stable finance.

This trade-off was most recently addressed last week by John Vickers, a former U.K. regulator. Commenting on proposals across the pond akin to those in the U.S. to expand the sovereign deposit backstop, Mr. Vickers cautioned that added coverage should come with higher regulatory capital to ensure that banks do not take undue advantage of the comfy quilt into which the current, porous safety net would be transformed.

The U.K. deposit insurance system is different than that in the U.S., most notably by the absence of costly, ex ante bank premiums for the privilege of deposit-insurance coverage. However, the U.S. risk-based premium system that sets bank premium payments is asset – not insured deposit – based. As a result, coverage could go up considerably without premium cost unless the FDIC changes its assessment scheme. This it will no matter what, but even higher premiums for still more coverage combined with tougher capital and liquidity rules will make it still less likely that any bank with options will hold more than a bare minimum of consumer deposits.

Deploying private coverage wherever possible could limits or even obviates the punitive costs of higher premiums and/or higher capital at least for those banks willing to acquire it. Private coverage won't be free – indeed, its cost might be so prohibitive that there's no alternative but to maintain the fiction of a deposit-insurance coverage ceiling. But, we won't know until we undertake the analytics essential to identifying the kinds of deposits best suited for credit risk transfer either directly by banks or via the FDIC. We need to know the policy-optimal level of deposit-insurance protection, the premium and regulatory cost of providing it, the market for private coverage, the resilience of said market, and resulting private-sector CRT feasibility.

Without an option, U.S. regulators could well decide that still-higher premiums, liquidity, and capital requirements for all insured depositories are the right price for greater federal protection. Indeed, with a bigger federal lifeline should come tougher standards. Still, U.S. banks will then be even more hard-pressed to compete in core intermediation sectors and the U.S. financial system will grow still more shadowy and inequitable. If there's a better way, we should pursue it as quickly as possible.