THE MORAL HAZARD OF INCREASED DEPOSIT INSURANCE: WHAT THE 1980S SAVINGS AND LOAN CRISIS CAN TEACH US ABOUT RESPONDING TO THE CURRENT FINANCIAL CRISIS

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I. THE HISTORICAL UNDERPINNINGS OF DEPOSIT INSURANCE

Banks play an integral role in the economic life of a country. Their role includes facilitating payments between consumers, serving as intermediaries between lenders and borrowers, and reflecting monetary

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policy—all while striving to operate in an effective and efficient manner.\textsuperscript{2} Although stock and bond markets may perform some of the same functions, banks are one of the few investment and financial mechanisms available to consumers of all economic classes.\textsuperscript{3} It is this far-reaching influence on consumers and the financial system as a whole that provokes the government to ensure the survival of banks.\textsuperscript{4}

In the years leading up to and following the stock market crash of 1929, the United States experienced bank failures at increasing rates.\textsuperscript{5} Between 1930 and 1932, these rates climbed to an average of 1,700 bank failures per year, and in 1933, peaked at slightly above 4,000.\textsuperscript{6} In an effort to repair the dismantled banking sector, Congress passed the Banking Act of 1933, which amended Section 12B of the Federal Reserve Act and created the Federal Deposit Insurance Corporation (FDIC).\textsuperscript{7}

Representative Henry B. Steagall played an integral role in the creation of the FDIC, for he proposed legislation to create the agency and worked to overcome opposition posed by the Roosevelt Administration, members of the banking industry, and fellow congresspersons.\textsuperscript{8} Senator Carter Glass, who served as Chairman of the Senate Banking and Currency Committee, also held his own ideas concerning banking reform.\textsuperscript{9} Although Senator Glass did not include bank deposit insurance as part of his initial reform agenda, he eventually surrendered to public opinion and “allowed [it] to be written into [the] banking bill that he had sponsored.”\textsuperscript{10} In May 1933, both Senator Glass and Representative Steagall introduced banking reform bills in their respective congressional houses, each of which

\begin{itemize}
  \item \textsuperscript{2} Id.
  \item \textsuperscript{3} See id. at 8–9 (noting the stock and bond markets are not accessible by all consumers).
  \item \textsuperscript{4} See id. at 9 (“[W]hile it is counter-productive to guarantee the survival of individual banks, authorities seek to protect the system as a whole.”).
  \item \textsuperscript{5} See John R. Walter, Depression-Era Bank Failures: The Great Contagion or the Great Shakeout?, \textsc{Fed. Res. Bank of Rich. Econ. Q.}, Winter 2005, at 39, 44 (stating that from 1921 to 1929 there were five hundred to one thousand bank failures per year).
  \item \textsuperscript{6} Id. at 45.
  \item \textsuperscript{8} \textsc{Fed. Deposit Ins. Corp., supra} note 7, at 40.
  \item \textsuperscript{9} Id. at 41.
  \item \textsuperscript{10} Id.
\end{itemize}
included deposit insurance provisions. Within the next month, both houses passed banking bills that were subsequently sent to a joint conference committee. On June 16, 1933, President Franklin Roosevelt signed the Banking Act of 1933 into law. Deposit insurance initially resolved the unstable banking environment of the Great Depression era by assuring depositors that banks were safe and restoring confidence in the banking system.

The creation of the FDIC is considered a defining moment for the United States banking industry, where it is regarded as a principal component that contributes to bank institution safety. While deposit insurance has played a vital role in the soundness of financial institutions within the United States, it has been criticized since its inception—on both practical and philosophical grounds. An important philosophical argument against deposit insurance concerns “moral hazard.” Moral hazard is defined as “the greater tendency of people who are protected from the consequences of risky behavior to engage in such behavior.” In banking, moral hazard is illustrated by banks incurring greater levels of risk than is advisable, while maintaining the attitude that the safety net of deposit insurance will protect them from any loss or failure they might incur as a result of this risky behavior.

This Note will explore the role moral hazard has played in the development of the banking sector and the ways in which Congress has responded to these changes, particularly through legislation. A comparison of the Savings and Loan Crisis of the 1980s and the current financial crisis will aid in this analysis, and it will focus primarily on how raising deposit insurance coverage may influence institutional behavior and moral hazard.

11. Id.
12. Id. at 42–43.
16. See Fed. Deposit Ins. Corp., supra note 7, at 40 (indicating criticisms based on “defunct state-level deposit programs,” “remov[al] [of] penalties for bad management,” the high cost of implementing such a program, and “unwarranted intrusion by the federal government into the private sector”).
18. Id. at 211.
Finally, this Note will explore possible solutions to the moral hazard posed by deposit insurance and consider how the banking sector and federal government should move forward following the most recent financial crisis.

II. FINANCIAL CRISIS RESPONSE: 1980 TO PRESENT

In the early 1980s, factors including the rise in world oil prices; inflation rates that peaked at twenty percent; interest rate ceilings imposed on banks; and “unprecedented economic expansion, high interest-rate volatility, low personal savings rates and unstable deposit flows” that resulted in “disintermediation,” sparked a financial crisis.\(^{19}\) Disintermediation is the phenomenon that resulted when market rates exceeded the interest rate ceilings banks and savings and loan institutions were allowed to pay, which consequently prompted consumers to invest their money in nontraditional depository institutions.\(^{20}\)

In an effort to relieve the ailing financial system during that time, Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA).\(^{21}\) The legislation contained provisions that would phase out the interest rate ceilings over a period of six years, enabling depository institutions to “compete with the high-yielding instruments available on the open market.”\(^{22}\) Also included in the legislation was an increase in the amount of deposit insurance coverage, from a rate of $40,000 per depositor to $100,000 per depositor.\(^{23}\) Congress viewed this increase as a vehicle to meet the inflationary needs for deposit protection, while also stabilizing the flow of deposits into depository institutions.\(^{24}\)

The next and most recent increase in the rate of deposit insurance coverage came in 2008, twenty-eight years after the 1980 increase. Once again the increase came through legislation enacted by Congress in

response to a national financial crisis. It is important to note, however, that even before the looming financial crisis of 2008 prompted this rate increase, federal deposit insurance had already undergone significant changes. The late 1990s did not lend itself as an era for vast discussion of deposit insurance because the economy was booming and banking conditions were favorable—meaning any discussion of deposit insurance reform was essentially tabled. In the early 2000s, however, discussions concerning the increasing or indexing of the rate of deposit insurance began to surface. In 2002, the American Bankers Association commissioned a study regarding the effect of a proposed increase in the deposit insurance rate, noting the current deposit insurance rate of $100,000 had lost over half its real value due to inflationary devaluation. On February 8, 2006, FDIC reform finally came to fruition when President George W. Bush signed the Federal Deposit Insurance Reform Act of 2005. Provisions of this Act allow the $100,000 maximum deposit insurance amount to be indexed for inflation each year, for five years, beginning on April 1, 2010—upon approval by the FDIC or the National Credit Union Administration.

From 2003 to 2007, financial institutions assumed excessive risk by leveraging low-cost, short-term debt against “long-term, illiquid, risky assets,” particularly residential mortgage holdings. When the cost of issuing such debt finally rose in August 2007, the subprime mortgage crisis emerged. Over the course of the next thirteen months, Americans
witnessed the bailout of Bear Stearns,\textsuperscript{33} the filing of Chapter 11 Bankruptcy by Lehman Brothers,\textsuperscript{34} the failure of Washington Mutual and subsequent acquisition by JPMorgan Chase,\textsuperscript{35} the sale of Merrill Lynch\textsuperscript{36} and Wachovia\textsuperscript{37} to Bank of America and Wells Fargo, respectively, the government bailout of AIG,\textsuperscript{38} and the placement of Freddie Mac and Fannie Mae in government conservatorship.\textsuperscript{39}

credit history, and employment status” (citations omitted)).

\textsuperscript{33} Moran, \textit{supra} note 32, at 56–58. On March 14, 2008, the Federal Reserve Bank of New York and JPMorgan Chase provided Bear Stearns—one of the world’s largest investment banks and securities firms—with a twenty-eight-day emergency loan. \textit{Id.} at 57. The loan was to provide capital for Bear Stearns to cover mortgage-related losses and prevent its demise. \textit{Id.} Recognizing this emergency loan would not be enough to bolster the institution, Bear Stearns was sold to JPMorgan Chase. \textit{See id.}

\textsuperscript{34} \textit{Id.} at 61–64. The collapse of Lehman Brothers on September 15, 2008, was fueled by its dealings in mortgage-backed securities. \textit{Id.} at 62. The largest problem with these mortgage-backed securities derived from the fact there was not an established marketplace to trade such securities and no real understanding of the degree of risk posed by their failure. \textit{Id.}

\textsuperscript{35} \textit{Id.} at 69. As the sixth largest bank in the United States, Washington Mutual’s failure was the largest in American history. \textit{Id.} Its problems stemmed from lax lending practices and insufficient liquidity as depositors pulled their investments. \textit{Id.} The bank was closed by its regulator, the Office of Thrift Supervision, appointed into the receivership of the FDIC, and sold to JPMorgan Chase. \textit{Id.}

\textsuperscript{36} \textit{Id.} at 63–66. On September 14, 2008, Merrill Lynch—the nation’s largest brokerage firm—sold itself to Bank of America for $50.3 billion after incurring losses of $45 billion on its mortgage investments. \textit{Id.} at 64.

\textsuperscript{37} \textit{Id.} at 69–71. Wachovia’s demise can be pinned to a single event—its acquisition of Golden West Financial Corporation in May 2006. \textit{Id.} at 69–70. Under this acquisition, Wachovia was exposed to subprime mortgages in California and Florida, two hard-hit markets when the real estate bubble burst. \textit{Id.} at 70. Recognizing the potential for failure in an economy plagued with financial-institution failure, the Federal Reserve approved Wells Fargo’s offer to take over Wachovia’s operations on October 12, 2008. \textit{Id.}

\textsuperscript{38} \textit{Id.} at 66–68. AIG’s participation in credit-default swaps was deeply affected by downgrades in its credit ratings. \textit{Id.} at 66. As its credit ratings fell, investors demanded more collateral. \textit{Id.} Unable to provide this collateral, the Federal Reserve provided AIG with an $85 billion emergency line of credit on September 16, 2008. \textit{Id.} Subsequently, the Federal Reserve “was promised a 79.9% stake in A.I.G.” \textit{Id.} at 66–67. In mid-November 2008, the federal government recognized some pitfalls in its original bailout package to AIG and replaced it with a new package worth about $150 billion—about $65 billion more than the original package. \textit{Id.} at 67–68.

\textsuperscript{39} \textit{Id.} at 60–61. On September 7, 2008, Fannie Mae and Freddie Mac were placed in government conservatorship as a result of the risks posed by the mortgage portfolios and mortgage-backed securities held by the two firms. \textit{Id.} at 60. The Treasury invested $200 billion in the preferred stock of the two firms and poured in another $5 billion to bolster their mortgage securities. \textit{Id.} at 60–61.
In response to the fragile state of the economy following these events, Congress passed the Emergency Economic Stabilization Act of 2008.\textsuperscript{40} Included in the Act was a temporary increase in FDIC deposit insurance coverage—from $100,000 to $250,000—until December 31, 2009.\textsuperscript{41} While a primary purpose of the Act as a whole is “to restore liquidity and stability to the financial system of the United States,”\textsuperscript{42} the Act’s deposit-insurance provision may also be regarded as a way to bolster consumer confidence in the United States’ financial system during a period of financial distress.\textsuperscript{43}

Although the temporary increase in deposit insurance was slated to last until December 31, 2009, under the Emergency Economic Stabilization Act of 2008, this period was extended by passage of the Helping Families Save Their Homes Act in May 2009.\textsuperscript{44} On July 21, 2010, with President Barack Obama’s signing of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the standard maximum deposit insurance amount (SMDIA) was permanently increased to the rate of $250,000.\textsuperscript{45}

While an increase in the rate of deposit insurance may reinforce consumer confidence in the United States’ financial sector, someone will still be left to foot the bill accrued by risk-seeking, profit-motivated financial officers. Bank failures are estimated to cost the FDIC nearly $65 billion through the year 2013.\textsuperscript{46} In 2010, a total of 157 banks failed, topping the 140 banks that failed in 2009.\textsuperscript{47}

\begin{footnotesize}
\begin{enumerate}
\item Pub. L. No. 110-343, § 136(a)(1), 122 Stat. at 3799 (to be codified at 12 U.S.C. § 5241(a)(1)).
\item See Jann Swanson, \textit{Call for FDIC Increase Aimed at Reassuring Bank Customers}, MORTGAGE NEWS DAILY, Oct. 1, 2008, http://www.mortgagenewsdaily.com/10012008_fdic_increase.asp (writing, before the Act’s passage, the proposed increase in deposit insurance is “a psychological tool to help alleviate some of the panic sweeping through the American population”).
\item Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, § 204(a)(1)(A), 123 Stat. 1632, 1648 (to be codified at 12 U.S.C. § 5241(a)(1)) (providing the level of FDIC deposit insurance will remain at $250,000 until December 31, 2013—four years longer than originally provided by the 2008 Act).
\end{enumerate}
\end{footnotesize}
and 2010 was nearly six times the number of bank failures combined—a total of fifty-two—from the years 2000 to 2008.48 While these bank-failure rates are not even remotely near the rates that plagued the United States in the early 1930s, they are still troublesome.49

III. THE MORAL HAZARD OF DEPOSIT INSURANCE

A. The Conditions of Moral Hazard

Moral hazard is the concept that with the presence of insurance to protect against potential loss comes reduced incentive for insured parties to act in ways that minimize loss and an increased incentive to engage in risky behavior.50

In insurance settings, there are two conditions that, when met, can lead to moral hazard.51 The first condition regards the insured party engaging in risky behavior.52 With insurance as a safety net, the insured party has less incentive to act in a cautious manner and more incentive to incur risks that might cause the particular harm the insurance is meant to protect against in the first place.53 The second condition concerns the costs associated with the insurer’s ability to enforce requisite behavior.54 Although an insurer may be able to require that insured parties behave in certain ways under the insurance contract, the enforcement of this requirement does not come without cost.55

49. See Walter, supra note 5, at 45 (noting the number of bank failures per year averaged 1,700 from 1930 through 1932 and peaked at over 4,000 in 1933).
50. See Tom Baker, On the Genealogy of Moral Hazard, 75 TEX. L. REV. 237, 239 (1996) (stating “moral hazard” refers to the tendency for insurance against loss to reduce incentives to prevent or minimize the cost of loss” (citations omitted)); see also Moran, supra note 32, at 50 (defining moral hazard as “the notion that those protected against certain risky behavior have an incentive to engage in such activities”).
52. Id.
53. Id.
54. Id.
55. See id. (providing the example of an automobile insurance provider requiring the insured to drive cautiously and enforcing this requirement by raising insurance premiums if the insured receives traffic tickets or submits accident claims).
B. Government Intervention to Prevent Bank Failure

Initially, deposit insurance was viewed as a governmental means to ensure continued stability within the monetary system of the United States. The creation of federal deposit insurance, however, has meant bank runs are no longer the sole identifier of eras of financial turmoil, and banks that are on the verge of failure may be allowed to continue operating and generating losses. When banks know this governmental “safety net” of deposit insurance will catch them if they fall, they may take actions and exceed the level of risk they would normally be willing to incur. Moreover, when the cautious risk-taking behavior of banks is dissolved, the potential for poor bank-lending practices increases. One way to curb such risk taking is through “the bank supervision and examination process.” Invoking a regulatory framework, however, involves high economic costs, and efficiency “demands that the costs of regulation do not exceed its benefits.”

To the contrary, where there is no deposit insurance system in place, “bank owners typically eschew undue risks or are constrained by the possibility that depositors and other creditors will demand risk premia and eventually run.” This suggests that without the “safety net” of deposit

56. Bradley, supra note 22, at 5.
58. Schwarcz, supra note 17, at 211.
59. Id. (stating that in addition to increasing risk exposure, a bank may reduce its capital ratios when it knows such risky behavior will be protected by the presence of deposit insurance).
61. Id.
62. See Schwarz, supra note 17, 209–10 (indicating high economic costs are incurred when government employees are charged with regulating and monitoring institutional compliance).
63. Garcia, supra note 1, at 23; see also John K. Pearson, Dillon Jackson & Tim Nohr, Ending the Judicial Snipe Hunt: The Search for the Cramdown Interest Rate, 4 AM. BANKR. INST. L. REV. 35, 53 (1996) (“A risk premium is a charge by a bank which is essentially an insurance premium protecting the bank in the event a borrower defaults on a loan.”).
insurance to catch them if they fall, banks will act with more caution and consider the far-reaching effects their risky decisions could have on the parties involved.

C. Using Federal Deposit Insurance to Hedge Risk

Banks have limited liability in the presence of deposit insurance.\textsuperscript{64} This limited liability can have detrimental effects on the banking system by increasing the potential for moral hazard as a bank’s net worth decreases.\textsuperscript{65} Even if a bank’s net worth approaches zero or a bank becomes insolvent, the presence of deposit insurance allows the bank to continue attracting depositors.\textsuperscript{66} So, although it may be risky for a bank to take on additional deposits that it may not be able to guarantee, the presence of deposit insurance reduces this concern.\textsuperscript{67} In this context, a bank is hedging a risk for failure against a desire to continue operation by attracting more business—regardless of the risk involved.\textsuperscript{68}

In addition to continuing its operation, a bank may view its limited liability in these circumstances as a way to offer depositors a risk-free rate of return.\textsuperscript{69} The notion of a “risk-free” rate of return is illustrated by the fact that even if the bank fails, depositors will be paid in some way—by either the bank or the FDIC.\textsuperscript{70} Therefore, incurring additional risk does not pose any further consequences to the bank because it will only be forced to pay off depositor claims to the extent it is solvent, with the FDIC covering the excess costs once it becomes insolvent.\textsuperscript{71}

Moreover, parties whose interests are protected by the guarantee of deposit insurance “become less careful in their personal habits or business practices or deliberately exploit it.”\textsuperscript{72} For example, when banks attract

\textsuperscript{65} \textit{Id.} at 948–49.
\textsuperscript{66} \textit{Id.} at 949–50.
\textsuperscript{67} \textit{See id.} at 950 (“Depositors’ claims will either be honored by the bank prior to its insolvency or by the FDIC after insolvency.”).
\textsuperscript{68} \textit{See id.} at 954 (noting an incentive to delay closure exists and is accompanied by the hope a bank can rebuild and subsequently restore its capital position).
\textsuperscript{69} \textit{Id.} at 949–50.
\textsuperscript{70} \textit{Id.} at 950.
\textsuperscript{71} \textit{Id.}
\textsuperscript{72} Garcia, \textit{supra} note 1, at 22.
depositors at a risk-free rate of return, shareholders may be more willing to let bank managers undertake risky investments that have the potential for higher returns. This gamble is inconsequential to shareholders because they have nothing to lose. The funds being gambled are essentially those of the FDIC because it is those funds that will be used to restore any loss the bank incurs upon insolvency. This exploitation of FDIC funds is problematic and exemplifies the moral hazard faced by bank managers and shareholders alike.

D. The Role of Depositors

While not in direct management or ownership positions like managers and shareholders, depositors play an important role in bank monitoring. With the presence of deposit insurance, depositors are more inclined to take a hands-off approach with respect to monitoring their bank's activities. This hands-off approach also means depositors may be isolating themselves from learning of the risky activities their banks are conducting. The scope of monitoring depositors should be expected to undertake, however, is influenced by a variety of factors. It is not reasonable to expect an average individual investor or small business depositor to possess “the time, inclination, or skill to evaluate” a bank’s financial soundness. Such tasks may only be plausible for extremely large or sophisticated depositors. For this reason, some economists—especially those supporting a free-market theory—think removing deposit insurance may be a better way to ensure depositors continue to play an active role in monitoring their banks' decisions.

As long as deposit insurance continues to play an integral role in the
United States banking system, governmental agencies such as the Board of Governors of the Federal Reserve System, the FDIC, the Office of the Comptroller of the Currency, the Federal Reserve, the National Credit Union Administration, and the Office of Thrift Supervision will be vital to monitoring the safety and soundness of banks across the country.83

E. Too Big to Fail

Under a “too big to fail” theory, the government acts to preserve large banks because their failure could give rise to widespread, adverse effects on the country’s financial system as a whole.84 While the prevention of far-reaching economic instability is a valid concern, providing enhanced backing to banks of such magnitude also exposes the government to a high degree of risk by virtue of the government ensuring adequate funding to rescue these troubled banks.85

The notion that a bank is “too big to fail” also generates a competitive advantage for large commercial banks by infusing “an aura of unlimited, de facto federal backing.”86 Depositors are especially inclined to believe large commercial banks are more stable under this theory and less risky as a result of portfolios that are more diversified than those of their smaller counterparts.87 It is important to remember, however, the extent to which certain banks are susceptible to the moral hazard imposed by deposit


84. Schwarcz, supra note 17, at 231 n.239; see also supra notes 33–39 (discussing current examples of institutional failures and the government’s response to each failure, particularly those deemed so large and intricately tied to the American economy that their collapse could jeopardize not only the American economy, but the global economy as well).

85. Broome, supra note 60, at 147.


87. Garcia, supra note 1, at 17.
insurance varies depending on a bank’s characteristics. For example, banks that are publicly owned and managed by salaried agents, as well as those with greater capital reserves, are less likely to participate in activities associated with excessive risk.

Because real variances exist regarding the size and structure of banks, which ultimately affect the amount of risk an institution is willing to incur, the application of risk-related deposit insurance premiums is one mechanism that should be used to curb excessive risk taking. A solution based on risk-related premiums requires an assessment to determine a fair premium based on portfolio risk, while also serving to “internalize all of the costs of risk-taking.” In the absence of risk-related deposit insurance premiums, however, depository institutions are motivated to assume risky investments to a greater extent than they would if deposit insurance was not a source of protection, despite undertaking risky activities.

IV. MORAL HAZARD THEN AND NOW: WHAT THE 1980 DEPOSIT-INSURANCE INCREASE CAN TEACH US WHEN RESPONDING TO THE CURRENT DEPOSIT-INSURANCE INCREASE

A. Moral Hazard and the Post-1980 Increase

In 1980, the deposit-insurance coverage limit was raised to $100,000—more than double the 1974 limit of $40,000. It is interesting to note this rate increase was not the main purpose of the legislation passed in 1980 and has been retrospectively described as an “‘afterthought,’” passed “‘with little debate and no congressional hearings.’” Particularly problematic is

89. Id.
91. Halpert, supra note 14, at 529.
92. Id. at 509–10.
94. See Bradley, supra note 22, at 18 (citations omitted) (noting that in the late 1980s and early 1990s, information surfaced indicating the passage of the rate increase did not undergo the normal procedures of debate, hearings, or public review, but occurred in a late-night conference committee meeting).
the fact the legislation nearly doubled the rate of deposit insurance coverage, yet no fervent debate occurred regarding the use of the $100,000 figure as the new limit.95

While Congress intended this increase in deposit insurance to assist banks in attracting new deposits, some critics believe this increase was “disproportionate” as a result of the extensive scope of coverage it provided and was one of the contributing factors to the savings and loan crisis that transpired in the 1980s.96 More specifically, this increase in the rate of deposit insurance led to increased deposits at banks and thrift institutions, which in turn led to moral hazard by encouraging insured institutions to behave in manners that were much riskier than they would have behaved if they were uninsured.97 Narrowly tailored statutes further aggravated the problem by permitting a single depositor “to have as many $100,000 accounts as he wished in separate banks” and “to have several accounts in the same bank so long as they were legally different.”98

In the face of the savings and loan crisis, however, thrift institutions failed, while commercial banks, having almost an identical form of insurance, did not.99 This result has prompted some scholars to question whether the savings and loan crisis indicated the notion of deposit insurance was sound and thrifts were the real problem, or whether deposit insurance at commercial banking institutions was a disaster still waiting to unravel.100

It is important to note that, in addition to the deposit-insurance increase in 1980, thrifts were simultaneously deregulated under DIDMCA101 and the Garn-St. Germain Depository Institutions Act of 1982 (Garn-St. Germain).102 DIDMCA brought reduced net-worth

95. *See id.* at 18–19 (revealing that although the rate increase was intended to address inflationary concerns and increase deposits, there was no ardent debate concerning why the new rate would not be the lower figure of $60,000, proposed by FDIC Chairman Irving Sprague).
97. *Id.* at 438.
98. *See* Carl Felsenfeld, *The Savings and Loan Crisis*, 59 FORDHAM L. REV. S7, S30 (1991) (noting “legally different” may include a depositor holding one account in his or her name, one as a joint account, and another in trust).
99. *Id.*
100. *See id.*
requirements and strengthened the authority of thrifts to extend loans for acquisition, development, and construction, while Garn-St. Germain loosened capital requirements for thrifts—only requiring capital reserves be “‘adequate’”—and eliminated previously enacted statutory limits on “loan-to-value ratios.” Such deregulation was intended to provide relief for thrift institutions until interest rates stabilized and asset portfolios could be restructured.

The deposit-insurance-coverage increase, paired with government deregulation, created an environment in which excess risk taking thrived—just as early federal deposit insurance critics predicted might happen. While deregulation can be advantageous under proper circumstances, the savings and loan crisis reveals deregulation may actually contribute to excess risk taking, and for this reason, the government needs to strike a balance between costly overregulation and complete deregulation. The governmental deregulation of thrifts during the savings and loan crisis cannot be ignored and must also be factored into an analysis regarding the relationship between deposit insurance, moral hazard, and the subsequent savings and loan crisis that occurred.

In 1991, law professor Carl Felsenfeld compared the state of commercial banks in the early 1990s to that of thrift institutions in the late 1970s. He wrote that if there was soundness in the commercial banking sector, there was little concern that attention was not being focused on issues pertaining to deposit insurance. If, however, bank failures are anticipated, steps needed to be taken sooner rather than later to prevent

320, 96 Stat. 1469.


104. Pub. L. No. 97-320, § 202(d), 96 Stat. at 1492 (repealed 1989). A loan-to-value ratio is defined as “[t]he ratio, usu[ally] expressed as a percentage, between the amount of a mortgage loan and the value of the property pledged as security for the mortgage.” BLACK’S LAW DICTIONARY 1022 (9th ed. 2009).


107. Felsenfeld, supra note 98, at S30–31; see also Faculty: Carl Felsenfeld, FORDHAM U. SCH. OF L., http://law.fordham.edu/faculty/9991.htm (last visited Mar. 12, 2011) (providing more information about Professor Felsenfeld, as well as a list of his published works).

108. Felsenfeld, supra note 98, at S31.
such failures from occurring and protect the banking sector as a whole.

Although the proactive reform articulated by Professor Felsenfeld was a common-sense approach to such a problem, scholarship a decade later indicated the economic boom of the late 1990s hindered such reform and placed it on the “back burner.” This perhaps illustrates that even if problems are foreseeable, depending on the state of the economy, they will not necessarily be addressed, particularly when the economy is thriving.

B. Moral Hazard Today

1. A Dwindling Deposit Insurance Fund

Today, moral hazard has prevailed under the “too big to fail” mindset by providing large institutions an expectation they will be bailed out when they are on the brink of failure. The federal government’s arrangement of JPMorgan’s purchase of Bear Stearns has been perceived as one instance in which this recently occurred because the Federal Reserve vowed to protect JPMorgan, to a certain extent, for the risk it assumed on behalf of Bear Stearns.

Although government bailouts may be scorned, it is logical for the government to act in a preventative manner so the collapse of one bank does not have a domino effect and lead to the type of financial crisis deposit insurance was created to prevent in the first place. From June to September 2009, the Deposit Insurance Fund (Fund) declined in value by $18.6 billion, leaving the Fund with a balance of negative $8.2 billion. This decrease is attributed to an additional $21.7 billion of spending related to bank failures. At the time of the FDIC’s 2009 third-quarter report, the number of insured institutions that had failed that year was already at ninety-five. These insured institutions had combined assets of $104.7 billion, and their failures were estimated to cost the Fund around $25

109. Id.
110. See Coppola, supra note 19, at 429 (addressing deposit-insurance-coverage limits).
111. Schwarcz, supra note 17, at 231.
114. Id.
115. Id.
billion.\textsuperscript{116} At this rate, the Fund had expenditures of roughly one-quarter of a failed bank’s assets. Considering that in September 2009 the Fund provided backing for $5.3 trillion worth of insured deposits,\textsuperscript{117} widespread bank failures could wreak havoc on the Fund and leave it in an even worse position. Moreover, the inverse relation of rising deposits and a declining Fund balance could make the Fund less capable of providing adequate insurance to banks that fail and depend on it for assistance.\textsuperscript{118}

2. \textit{In Defense of a Rate Increase}

In crafting a possible solution to the matter of moral hazard, it is necessary to consider whether the current increase in the deposit-insurance rate was merely a quick fix that might not remedy the current situation but actually make it worse by “rais[ing] the probability and cost of instability in the future.”\textsuperscript{119} It is important to recognize that even if the rate increase had not passed under the Emergency Economic Stabilization Act of 2008, annual increases based on indexing were permitted to take place beginning in 2010 under the Federal Deposit Insurance Reform Act of 2005.\textsuperscript{120} Although the onset of the financial crisis of 2008 certainly accelerated the pace at which an increase in the rate of deposit insurance occurred, the Deposit Insurance Reform Act was undeniably important in bolstering the confidence of the American public and bringing stability to the financial sector.

In a statement to Congress, FDIC Chairperson Sheila Bair advocated for raising the insurance deposit rate in order to thwart “an increasing

\begin{footnote}
\textsuperscript{116} Id.
\textsuperscript{117} Id.
\textsuperscript{118} See id. (indicating the deposit insurance fund balance has declined in every quarter from March 2008 to September 2009, while the amount of deposits has increased by almost $1 trillion in this same period of time).
\textsuperscript{119} Garcia, \textit{supra} note 1, at 4.
\textsuperscript{120} Compare Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 136, 122 Stat. 3765, 3799 (to be codified at 12 U.S.C. § 5241(a)(1)) (providing an increase in the rate of deposit insurance from $100,000 to $250,000 per depositor), with Federal Deposit Insurance Reform Act of 2005, Pub. L. No. 109-171, § 2103(2), 120 Stat. 9, 10 (codified as amended at 12 U.S.C. § 1821 (2006)) (permitting the $100,000 maximum deposit insurance amount to be indexed for inflation each year, for five years, beginning on April 1, 2010, upon approval by the FDIC and the National Credit Union Administration).
\end{footnote}
crisis of confidence that is feeding unnecessary fear in the marketplace.”

With someone as influential to the financial sector as the FDIC Chairperson advocating for an increase in the rate of deposit insurance, it is still important to question whether increasing the rate of deposit insurance was the only mechanism that could be employed to bolster the confidence of the American public. While it is possible other measures—including the FDIC’s use of public service announcements about the benefits and limitations of deposit insurance—might have been effective, raising the rate of deposit insurance sent a timely message. Not only was the government responding to the current economic crisis, it was also exposing itself to extreme liability by virtue of the FDIC being backed by the “full faith and credit” of the United States government.

Although federal deposit insurance has not wholly eradicated the occurrence of bank runs, it has been notably successful in attaining this goal. The current financial crisis may reveal existing flaws within the deposit insurance system, but this is not grounds for eliminating the system altogether. For this reason, reform options must be analyzed and considered in light of past and present experiences in order to create a system that balances functionality with security, while mitigating the effects of moral hazard.

V. POSSIBLE SOLUTIONS TO MORAL HAZARD IN DEPOSIT INSURANCE

In response to the predicament of moral hazard, several solutions...
should be considered, although none of the proposed solutions should be expected to single-handedly solve moral hazard issues. While the permanent rate increase to $250,000 accomplished by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 is a step in the right direction, it is not a one-size-fits-all solution to the issues posed by moral hazard.\textsuperscript{125} Integration of the current system and a combination of the proposed solutions that follow, however, may create a system that meets the needs of depositors, while providing a framework that is workable for the government, its agencies, and banks alike. This Note will explore three possible solutions to the problem of moral hazard: indexing the rate of deposit-insurance coverage, replenishing the Deposit Insurance Fund, and imposing limitations on who can benefit from the Deposit Insurance Fund.

A. Indexing

Fixing the deposit-insurance rate to a price index is one possible solution to moral hazard. This proposed price-fixing option would keep increases in the rate of deposit insurance aligned with inflation and prevent the drastic and variable jumps in coverage—as occurred in both 1980 and 2008—from repeating. In the past, the FDIC has offered price fixing as a mechanism that could be used “to maintain the real value of deposit insurance coverage.”\textsuperscript{126} In particular, the FDIC advocated for the use of the consumer price index because, in addition to being “widely understood and accepted, quickly available, and track[ing] well with the rate of inflation[,] . . . other important government programs such as Social Security, Medicare, and taxes are indexed.”\textsuperscript{127} It is the success of these other large-scale governmental programs, paired with consumer familiarity with the underpinnings of indexing, that makes fixing the rate of deposit-insurance coverage to a price index a feasible response to moral hazard.

There are, however, practical limitations to price fixing that must be considered. Determining the time intervals at which the rate of coverage would increase, as well as when such increases would be triggered, is


\textsuperscript{127} Id. at 444 (citations omitted).
crucial to devising a workable indexing plan.\textsuperscript{128} Public policy issues that may arise can be addressed by keeping the coverage rate as a round number, prohibiting decreases in the amount of coverage, and alleviating depositors of the burden of constantly monitoring the rate to make sure they are adequately insured.\textsuperscript{129} Despite these mechanical obstacles, a detailed and specific indexing plan may serve a useful function in steadying the rate at which deposit-insurance-coverage increases and alleviating the effects of moral hazard.

B. Replenishing the Deposit Insurance Fund

With the existence of the Fund at the heart of the deposit insurance system, the FDIC will need to determine how to prevent the Fund from eroding.\textsuperscript{130} In response to the events that transpired in the fall of 2008, the FDIC increased the basis-assessment rates paid by financial institutions into the Fund, which averaged 6.4 basis points for all institutions in September 2008, to 15.4 basis points beginning on April 1, 2009.\textsuperscript{131} This rate increase was viewed as not only a method to restore the monetary value of the Fund, but also as a manner to improve the way in which risk is allocated between risky institutions and safer institutions.\textsuperscript{132} In 2008, the FDIC’s revenue from assessments was $3 billion, and based on the rate increase effective on April 1, 2009, the FDIC projected the Fund would generate $11.6 billion in 2009.\textsuperscript{133} While the 2009 assessment-rate increase did not prove to be a “quick fix” for the Fund—which it was never intended to be—current trends indicate that over an extended period of time, these increased assessment rates could salvage the Fund and restore it to pre-financial crisis levels.\textsuperscript{134}

\textsuperscript{128.} See id. (taking into consideration that timing determinants include “the particular percentage decline required to trigger an increase and a minimum time interval between each increase” (citing FDIC, supra note 126, at 19)).

\textsuperscript{129.} Id.

\textsuperscript{130.} See supra Part IV.B.1 (discussing the current state of the Fund, its decline in value, and the negative balance that has resulted from mounting bank failures in 2009).


\textsuperscript{132.} See id. at 9543 (revealing one goal of the new base-rate schedule is to “make the risk-based assessment system fairer, by limiting the subsidization of riskier institutions by safer ones”).

\textsuperscript{133.} Id. at 9545.

\textsuperscript{134.} See 74 Fed. Reg. 9564 (Mar. 4, 2009) (recognizing that the October 2008 Restoration Plan, which provided a five-year time period to restore the reserve ratio to
In September 2009, bankers and lobbyists supported an effort that would allow the FDIC to borrow billions of dollars from the nation’s “healthy banks” in an effort to replenish the Fund. At the time, financial analysts viewed this plan as something that was pleasantly ironic. Considering the current financial crisis has been notorious for government bailouts, the tables would be turned if the government relied on a bailout from healthy banks. In addition, the healthy banks that are lending to troubled banks may put more pressure on their peers to minimize risk taking, which may serve as a form of self-correction to the moral hazard risks posed by excessive risk taking.

Another logical way to restore the balance of the Fund is through the implementation of additional rate increases. While raising rates is generally not a popular idea, it might help alleviate moral hazard issues if banks have to pay more to protect deposits. Such pressure might help banks recognize that risky behavior does not come without cost. Further, in light of the current increase in deposit-insurance coverage, it only makes sense that banks pay a higher premium if they expect to receive higher coverage rates in return. Although the rate of deposit-insurance coverage increased by 250%, it admittedly might be a stretch to say deposit-insurance premiums should be increased in proportion to the increased rate of coverage.

C. Imposing Limitations on Fund Beneficiaries

The final solution offered is making the Fund available to only those insured financial institutions that have not abused their discretion or acted in manners that are inherently risky. While this approach may seem like a
harsh remedy, particularly with respect to innocent consumers, it may put pressure on consumers to take a more active role in ensuring financial institution managers adhere to both institutional and governmental policies.\textsuperscript{138}

It is recognized that this approach may raise concerns regarding the ability of a financial institution to undertake risky investments in order to achieve greater rates of return. Although financial institutions would not be encouraged to undertake high-risk investments, there should be disclosure provisions requiring that excessively risky products or practices be disclosed to consumers before they become customers of a particular institution or to existing customers if an institution later decides to participate in such ventures. Of course, determining when risky becomes “too risky” is another detail that would need to be ironed out.

\textbf{VI. CONCLUSION}

At first glance, an undercapitalized Fund seems problematic, but further analysis might actually render it a feasible solution to moral hazard.\textsuperscript{139} Because insured financial institutions may have an overly dependent relationship on the mere existence of a deposit-insurance fund and therefore take risks that are beyond their capacity, an undercapitalized Fund that does not guarantee an automatic bailout might actually serve as incentive for banks to act in manners consistent with their financial

\textsuperscript{138} See Broome, supra note 64, at 958 (highlighting one way to mitigate the incentive for risky behavior is to provide private parties with the tools “‘to monitor bank management and control excessive risk taking by banks,’” and that using such market forces will reestablish the notion there are trade-offs for risk and return (citations omitted)).

\textsuperscript{139} In 1991, the Treasury Department urged Congress to decrease the scope of deposit-insurance coverage in an effort to increase the role of market discipline over banks. Joo, supra note 51, at 1131 n.291. The proposition “was based on the theory that the lack of insurance would give depositors incentive to ‘discipline’ bank management by demanding higher returns to compensate for the risk of bank insolvency.” Id. (citing Broome, supra note 64, at 959). Congress deemed this scheme “politically impossible” and rejected it. Id. (citing Broome, supra note 64, at 959 & n.92). Although this approach was not supported twenty years ago, limiting the scope of deposit-insurance coverage may coerce banks into acting more responsibly and prevent them from receiving a government bailout if they engage in risky behavior. Moreover, the disturbing events of the current financial crisis might provide Congress greater incentive to protect only those banks that undertake risk within their means—and exclude those banks whose irresponsible behaviors pose the risk of jeopardizing the entire financial system.
capabilities. Perhaps it is not necessarily an undercapitalized Fund that is desirable, but a Fund that is only available to institutions meeting the most stringent compliance requirements.

At the end of the day, deposit insurance is a necessary component to a properly functioning banking system because it serves as a form of protection for depositors in the event of institutional failure, seeks to prevent widespread bank failures from disrupting the economic and political stability of the country, and gives depositors confidence in the financial institutions that play an integral role in their day-to-day lives. Despite the financial crisis that emerged in 2008, all hope for overcoming issues regarding moral hazard is not lost. Federal deposit insurance has overcome moral hazard in the past through the presence of “built-in mechanisms for monitoring and controlling moral hazard.”140 While the mechanisms utilized to monitor and control moral hazard may need to be revamped in order to adapt to changing economic circumstances, the advantage of living in a democratic society is that such change is possible, provided politicians on both sides of the aisle work to create meaningful reform aimed at curtailing the risks taken by depository institutions.141 Such reform, however, will not be the product of congressional action alone. Government agencies and banks themselves will need to take an active role in voicing their thoughts and concerns with proposed reform efforts, and consumers will need to articulate their expectations as well, for government agencies and banks alike. Finally, all parties will need to recognize such change will not automatically cure all that ails the economy, but it will hopefully restore stability and prevent the rise of another financial crisis.

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140. Moss, supra note 106, at 550.
141. See Barack Obama, President of the United States of America, State of the Union Address (Jan. 27, 2010), available at http://abcnews.go.com/Politics/State_of_the_Union/state-of-the-union-2010-president-obama-speech-transcript/story?id=9678572 (advocating financial reform and asserting “[w]e can’t allow financial institutions, including those that take your deposits, to take risks that threaten the whole economy”).