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GERALD P. O'DRISCOLL, JR.: BANK FAILURES: THE DEPOSIT INSURANCE CONNECTION CONTEMPORARY POLICY ISSUES VOL. VI, NO. 2, APRIL 1988

The banking system in some countries was at the brink of collapse, while in other countries it failed woefully. Consequently, policy response to banking failure in countries of experience has been some measure of intervention. Thus, as against the working principles of economics, favouring the unfettered working of market forces, regulations and regulatory institutions have been set-up by these countries to ensure the safety of depositors money as well as enhancing the stability, hence the confidence in the banking industry.

The existence of this regulatory body universally known as the Deposit Insurance established to prop up the working of the banking system as well as other regulations, are what the author contends with, believing that the banks would do better without a regulatory outfit. In doing this, the article is divided into five parts; part I is introductory, part II titled "Banking: Structure and Stability" reviews historically the coming into being of the Federal Deposit Insurance Corporation of the United States - a regulatory institution. Part III focuses on deregulation, and should emphasis be placed on assets or liabilities?; while part IV makes a case study of a crisis ridden thrift industry which lends support to his contention. Finally, part V assesses public policy and the pitfalls of protecting the banking industry.

SUMMARY OF ARTICLE

In the introductory part, the author articulated the views of Friedman and Schwartz who are unfavourably disposed to general regulation of the banking system but accepts the existence of deposit insurance; which in their view "was the most important structural change in the banking system to result from the 1933 panic". In a historical analysis into the problems that led to banking failure in the United States, and the resultant establishment of the Federal Deposit Insurance Corporation (FDIC), with other binding regulations on commercial banks, the author agrees with Friedman and Schwartz submission that annual bank failure declined from triple-digit to double-digit to single-digit. However, the Glass-Steagall act - the banking act that established the FDIC artificially segmented the banking industry which in the opinion of the author has abated the competitive forces within the banking industry. Such segmentation into commercial, investment and savings banking eliminated substantially competitive rivalry on a common field, and provided long-term stability. However, in a comparative analysis prior to the Glass-Steagall act, the author concluded that States that had the backing of regulatory deposit guarantee funds as against those that diversified by bank branching had "abject banking failures"; as the liabilities of the guaranteed funds greatly exceeded their assets". Hence, the banking act was effective only on the ground that it protected the unit banking system that failed to diversify into a net-work of branches; secondly, there was low bank failure; thirdly, that it reduced

competitive financial forces, the deposit insurance protected the unit banks adequately from possible failure. Therefore, the author posited that bank failure was reduced not on account of increased bank safety, rather, the substantial reduction of competition among financial institutions.

While emphasizing other regulations the authorities imposes on banks, the author noted that banks are usually prohibited from participating in equity investment in real estate or underwriting corporate securities considered to be inherently risky, but are allowed to give commercial loans and invest in government bonds considered less risky – this categorisation is based on the regulators' perception of average risk of assets as against the marginal risk of assets assessment by portfolio managers. In line with the risk perspective of portfolio managers, the author advocated for the deregulation of banks capacity to earn more assets; the granting of such maximum freedom for assets diversification enhances their assets base. As, in principle, the author emphasized, "adding to portfolios of risky assets can reduce overall risk". Similarly, the author argued that "inflationary forces, technological advances, and financial innovation combined to render obsolete regulation on interest rate on the liabilities of depository institutions". Hence, like the assets, the better option in the author's opinion is the complete deregulation on banks' liabilities. However, comparably, faced with the option of which to deregulate – assets or liabilities, a less optimal solution to the banking problem, the author opined that "regulating bank's powers or the composition of their portfolios have proved better options than their liabilities".

However, in the view of the author, the optimal solution lies with the complete deregulation on banks' assets and liabilities. The case study of the thrift crisis of Texas savings and loans industry was cited eloquently for the necessity of deregulating the banking system. Most of the managers of the Savings and Loans industry were incompetent and consequently regarded as "living-dead zombies". With unrefined managerial practices, and the eagerness to grow out of the prevailing problems, they increased their liabilities position which enhanced their asset base; unfortunately, however, the assets were undiversified that with the spread of negative interest by 1983, they suffered from asset quality problems. Conclusively therefore, the author said the existence of deposit insurance insulating and funding the operation of zombies who in a "never-ending attempt to grow out of ever-increasing losses" compete with solvent ones to bid up the cost of funds. And to salvage some of these zombies, solvent banks used to bail out insolvent ones may become insolvent in the process. This, the author noted cannot augur well for safe and sound financial system; except the insolvent ones peter out.

OBSERVATIONS AND CONCLUSION

The banking institution occupies a central position within the setting of any nation's economy; for this reason, it is not entirely left to the whims and caprices of economic forces. However, as an industry, it must be dynamic, inventive and innovative in meeting the changing circumstances of the time. In meeting the dynamics of the time within a given competitive environment, excessive regulations that interferes with the internal running of the banks would kill initiative and creativeness of banks to mobilise and allocate resources in the most efficient manner that would enhance dividend of shareholders. If, the essence of some of these regulations is to stabilise the banking

system and enhance customers' confidentiality, but in the same vein, unavoidably limiting the investment prospects of banks hence the profitability levels, amounts to the proverbial killing of the goose that laid the golden eggs. In this wise, as long as profit maximisation is the ultimate objective, excessive regulations on its assets and liabilities could be counterproductive. In consequence, banks, under the circumstance, devices ingenious ways of circumventing policy regulations to realise the expected profit levels. Empirical evidences in Nigeria shows that most banks established their finance houses and security affiliates to serve as vents through which customers or investors were directed and granted substantial loans and advances over and above the level stipulated. Others too, established bureau-de-change as avenues through which foreign currencies from official source were diverted in order to enhance their earning capacities at the black market; thus, perpetuating the incidence of round-tripping. In both examples, neither the reasons for the regulations nor the banks sufficiently prevented from granting loans above the prescribed maximum were achieved. However, the coming into force of decree 25 of 1991 bringing finance houses under close supervision and control would seal-off the age-long loophole. On the other hand, when treasury bills were deregulated, the 1990 annual report of the Nigerian Deposit Insurance Corporation (NDIC) shows that the resultant interest rate was very attractive and encouraged banks to invest more into treasury bills than before. Like any shrewd businessman, banks, as those examples show, are all out to make profit, the basis of their corporate survival; hence, they need less regulations approximate to a free enterprise environment to take advantage of market indicators.

It is in the light of this that one supports the view of the author advocating for the entire deregulation of the banking system. However, whether an entirely deregulated banking system would augur well for a developing economy like ours as against an advanced economy on which the author based his opinion is another issue altogether. Suffice to say here that, as long as banks recognize the need for sufficient liquidity to meet depositors request, and appropriate colateral security to assuage loans and advances granted, banks should be allowed to acquire any risky asset considered highly profitable. In other words, regulations limiting them to certain category of assets should be dismantled, and they should be granted the freedom to diversify by acquiring any asset no matter how risky, but adjudged highly profitable. Since profit making is the basis of their continued survival, highly risky assets with substantial profit margins would in effect reduce the overall risk standing. In this way, banks would be much more self-sustainable, relying less on the Central Bank of Nigeria and the NDIC insurance guarantee to bail them out at the slightest problem. Evidences have even shown that less risky assets, in the perception of regulators, such as commercial loans and government bonds are either less lucrative, contributing less to the overall profit margin, or ironically, increasing their risk standing. For example, of the nine distressed banks in the NDIC 1990 report, for every one naira (₦1) loan, 75k is incollectible – this, therefore, is the irony of less risky assets annihilating the very existence of these banks. Therefore, as long as profit is the prime motive of banks, they should be given the leeway to finance any investment or acquire any asset in diversifying their assets base to enhance their profit standing and indirectly safe-guarding depositors' interest. Assets diversification therefore supports the merits of the conventional wisdom that disapproves putting all investments into one basket; and, of course, risks are better spread with the resultant reduction of overall risk standing.

In the same vein, the liabilities of banks be deregulated; thus, under a deregulated atmosphere, efficiently run banks can flexibly and profitably adjust according to the dictates of the time. However, in Nigeria, with the deregulation of interest rates, deposit liability interest rate did not move as fast as the lending rate. Hence, the increasing divergency between the two rates got to levels uncomfortable to policy makers. At an estimated average of 32 per cent interest rate puts to question the reliability of absolute deregulation in a developing economy fraught with profound market imperfections.

Another issue raised by the author that is of practical relevance to the Nigerian context, partly if not wholly responsible for banking failures is the enthronement of inexperienced personnel to manage risk-taking institutions like banks. Aptly described, "the Texas Zombies" have their equivalents in Nigerian banking industry. Of the nine distressed banks reported by NDIC, among others, ineffective management by staff and board members whose appointments were not based on merit, administrative problems, internal wranglings leading to the polarisation of the rank and file, poor internal control systems characterised by poor loans and advances and fraud are some of the causes of distress which invariably are the hallmarks of inexperienced personnel at top management positions. In the author's opinion, any financial assistance by NDIC would imply funding the continued existence of the Nigerian banking zombies; who, in attempt to get out of their problems are in the habit of bidding up the cost of funds at the expense of solvent banks. Again, the NDIC request for a solvent bank to take over and manage a distressed bank can possibly lead to the distress of the managing bank. In this wise, NDIC has further accentuated the distressed nature of the banking industry.

However, much as the author does not see the relevance of a regulatory institution like the Nigerian Deposit Insurance Corporation (NDIC), one does not accept its scrapping because of the possible aforementioned defects. Frankly, a distressed bank should have been left to either swim ashore or sink as the case may be; however, the effects on the image hence the confidence of the banking industry cannot be underemphasized. It is axiomatic that a regulatory body cannot prevent a failing bank from going into eventual liquidation; however, it can possibly cushion the effects on the banking industry in salvaging a failing bank. This is necessary, because, the banking industry as an intermediary institution between the surplus and deficit units occupies a unique position in the workability and development of any economy that it must be well guarded to sustain the trust and confidence reposed on it. Therefore, the need for, and the role of a regulatory institution to safeguard the trust and confidence of customers is, basically, not to reinforce the existence of banking zombies. Run as an insurance outfit — serving as a common pool of risk to all insured banks, funds thereof are used to assist the insured but financially distressed banks. In the capacity of a consultant, and in addition to the financial assistance given, a regulatory institution can recommend and seek for the immediate replacement of incompetent zombies, these may go a long way to salvage an otherwise distressed bank to a buoyant one. In that same capacity, early warning information to owners of the bank which some management staff could have supppressed owing to the interest of their appointments can redress the situation in good time. Thus, the provision of management information with the view to curbing excesses likely to engender insolvency are some of the crucial roles of the Nigerian Deposit Insurance Corporation. For instance, it was observed that (NDIC 1990 Report) most of the poor loans granted were to State

governments, contractors handling State governments projects but unpaid for the workdone, and unsecured lending. Fraud which has risen to 666 per cent in 1990 was equally mentioned; in all these, the affected banks may have taken the necessary action to redress their critical situations, and in the long-run, enhance the stability of the banking industry.

At any rate, where a solvent bank is to assume the management of an insolvent bank, the probable course of action of the solvent bank is to avoid the pitfalls of the former managers of the insolvent bank. It should therefore, with the assistance of NDIC, avoid being drawn along by the deepening problems of the insolvent bank when it has become inevitable. Therefore, in the event of liquidation, NDIC plays a major role of an unbiased umpire assisting depositors to regain part if not substantial part of their deposits; thus, allaying the fears and agony of customers losing entirely their life time savings. Consequently, these roles can only be performed by an established regulatory institution which the author has strongly queried its relevance and thus argued for its scrapping.

From the foregoing, the necessity for regulatory institution does not in any way suggest excessive regulations on the activities of the banking industry. In fact, the NDIC roles are rather complementary, and do not as in the case of general regulations inhibit the banks' capability to acquire any asset or take on any liability. However, with respect to general regulations, and as noted above, the desirability for an entirely deregulated banking system in a developing economy as against the developed one remain questionable. In this regard, three basic interests are identifiable — namely, the interest of banks, the interest of depositors and the interest of the nation with respect to the running of the economy. Arguably, the deregulation stoutly defended in support of the views of the author tally with the interest of the banks. An interest which allows banks to acquire any asset or take on any liability as they deem it necessary in the ordinary course of their businesses without regulatory inhibitions. Secondly, in disagreeing with the author as regards the position of a regulatory institution such as the NDIC, the interest of depositors was the uppermost. Because, every action to safeguard banks boils down to protecting depositors from unexpected losses. However, when the interest of the nation is considered, moreso in a developing economy characterised with profound market imperfections and observed perverse behaviour of some basic economic parameters, it is difficult to leave the banks in the world of their own. Because, the interest of individual banks does not align with the national interest which has led to non-compliance, manipulations to sidetrack policy stipulations. For example, when interest rates were deregulated, market forces did not produce the desired results acceptable to policy makers — this is so, because of structural deficiency, institutional rigidity and imperfect flow of information among others. Policy response to interest rates behaviour was some measure of intervention; therefore, in this regard, there must be some form of regulatory interventions that seek to fine-tune the economy towards the path of growth and development other than the micro behaviour of banks. Interestingly, the national interest of monetary authorities would be enhanced when indirect monetary policies come into play without sacrificing banks interest. At that time, each interest would be almost safeguarded hence unviolated.

Another point of difference with the author lies with his observed opinion that the reduction in competition owing to the segmentation of the banking industry into three specialised fields accounted substantially for the low bank failure achieved by the

deposit insurance. Admittedly, the Glass-Steagall act in segmenting the banking industry into commercial, investment and savings banking, perhaps, for the purposes of specialisation and efficiency, the observed fall in competitive rivalry must be a momentary phenomenon. As, overtime, in each banking field, competition would become very intense, does that presuppose that there cannot be other means of ensuring low bank failure? Certainly, in addition to the roles of NDIC, safety measures such as the prudential guidelines, capital adequacy requirement would go a long way to ensuring safe and sound financial system.

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