THE WALL STREET JOURNAL.
WSJ.com

OPINION

SEPTEMBER 17, 2008

Loosen Deposit Insurance Rules To Prevent a Bank Run

By LAWRENCE B. LINDSEY

Let's get over the finger pointing. The media and political class are seeking someone, anyone, to blame for the current financial market meltdown: regulators allegedly asleep at the switch, lax monetary policy, greedy Wall Street executives. But there are far more well-intentioned culprits and far fewer pure victims than we would like to believe.

Corbis

For two decades, politicians demanded ever easier access to mortgages for their constituents. In the name of shareholder value, financial firms were pushed to add leverage and reduce reserves. Even those usually thought of as victims -- such as homeowners making $50,000 who thanks to creative mortgage finance and few demands for documentation moved into homes once occupied by people making six-figure salaries -- should have known something was up.

History suggests it was always this way. Even Isaac Newton, of gravity fame but who also held the position of master of the mint, lost money in the South Sea Bubble. He got out, thinking it was a bubble, then got back in when it kept going up. He lost a small fortune in the process when it finally collapsed. Human greed, coupled with hubris, hasn't changed in the four centuries for which we have some sense of economic history.

So what's next? First, we need to build a firewall at a place far from the immediate flames, just in case the fire gets there. Second, we have to take a good measure of discretion out of the financial regulatory process. Rules were replaced with ever-so-sophisticated computer models, the parameters of which only included data from a market that was moving up.

The place where we absolutely must build a firewall is around the payments system. It is hubris to assume that the health of our commercial banking system will be untouched by recent events, and that we have built good-enough safety nets in the last 70 years that we need not worry. Nearly 40% of the assets in the banking system are not protected by FDIC insurance because they are in accounts that exceed the $100,000 insurance limit. Most of these are not "investments" in the usual sense of the word. They are often the transaction accounts of businesses that have to meet payrolls and pay vendors. If you have to make a biweekly payroll for 50 people, it is sheer folly to expect the paychecks to be drawn on accounts in three or four separate banks. Sometimes individuals who would normally keep a balance well under $100,000 might be over the limit to make a downpayment on a house, purchase a car, or pay quarterly taxes.

It is also foolish for Washington to expect businesses to risk bouncing their payroll checks, or individuals to bounce a car payment, because the regulators decided to close a particular bank over a particular weekend. Should it look like this might happen, we will instead have a run on our banking system with enormous consequences. Mistakenly, the left favors a cap so as not to "bail out the rich." The right favors a cap expecting depositors to impose "market discipline" on the bank. Congress must put ideology aside and, before going home to campaign, fix this by removing the cap on FDIC insurance in transaction accounts like checking and money-market accounts.

Second, as the dominant regulator in the field, the Federal Reserve must draw up guidance for credit- card lenders regarding the reduction in lines of credit. Currently these are computer-driven. With statistical risks on many accounts likely to grow and capital scarce for providers, cardholders might begin to face widespread reductions in their lines of credit. The unused credit on these cards is for many households the functional equivalent of reserve liquidity for financial firms. Do away with it, and consumer spending may take a tumble.

Finally, with these firewalls in place, we need to change our approach to defining capital adequacy by announcing new rules to take effect in 2010 or 2011, thus giving financial institutions time to adjust. Following Sarbanes-Oxley we gave accountants the power to use overly precise and inflexible values for assets, and compensated by allowing firms to use highly flexible and history-driven models to apply those values to test for capital adequacy.

This gets it exactly wrong. Many assets are highly illiquid and the institutions that hold them, such as banks, are in the business of providing liquidity to the economy and holding such assets as collateral. Making those assets "mark to market" meant that reserves were drawn down and converted into ever more loans during the upswing, and now must be built back up at a time when asset prices are plummeting and capital is scarce. Instead, a more stable capital adequacy rule -- such as a leverage ratio that was based on the original asset values -- would limit this pro-cyclical behavior. This means that the complex approach taken in the Basel II discussions for international capital rules need to be scrapped, and the process restarted.

It may be a distant memory, but before "risk-based" capital rules and "Level 3" assets we used to have binding leverage ratios for both commercial banks and investment banks. They had their flaws. But the main reason both management and regulators did away with them was that seemingly "scientific" alternatives seemed better, especially since they were so much more flexible in changing conditions. The lesson of the current experience is that market conditions and political objectives may change, but human motivations endure.

Mr. Lindsey, former assistant to the president for economic policy, is president and CEO of the Lindsey Group, and author of "What a President Should Know . . . But Most Learn Too Late" (Rowman & Littlefield, 2008).