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Depositor discipline and changing strategies for regulating thrift institutions

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Abstract

This paper examines the role of uninsured deposits as a source of thrift funding from 1984 to 1994, and tests whether uninsured depositors have adjusted their holdings at thrifts in response to market forces, such as indications of impending institutional failure. It also examines how the reactions have changed over time as new legislation has been implemented. The study finds that failed institutions exhibit declining proportions of uninsured deposits-to-total-deposits prior to failure and that failing institutions attract fewer deposits from uninsured depositors prior to failure than do solvent institutions. Though there are some differences between the periods, the empirical results indicate that uninsured deposits will be governed by market discipline and that reducing the insurance limits on deposits will increase market discipline on thrifts.

JEL classification: G21

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1. Introduction

Perverse incentives created by deposit insurance have contributed significantly to the failure of large numbers of banks and thrifts in the 1980s and early 1990s and led to a reexamination of deposit insurance. Holders of uninsured deposits have more to lose from failure of depository institutions than do insured depositors, and would be more likely to respond to impending failure. The insured depositor may be

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concerned about maintaining a valuable banking relationship. Impending failure may lead to shifting of insured deposits to strengthen an alternative banking relationship as a precaution against closure. This paper tests three hypotheses about the behavior of uninsured deposits in response to impending failure, changes in the financial health of thrifts, and changing thrift regulations. The empirical results indicate that the uninsured deposit component of thrift funding is governed by market discipline and is affected by changing regulations.

Large and positive duration gaps, in the face of increasing interest rates, adversely affected the institutions beginning in the mid-1960s. The federal regulators attempted many patchwork solutions directed at reducing interest rate risk and simulating solvency at troubled thrifts as outlined in the Depository Institution Deregulation and Monetary Control Act (DIDMCA) of 1980 and the Garn-St. Germain Act of 1982. The federal government failed to come to grips with the problems of the 1980s and followed a policy of forbearance partly due to the inability of the Federal Saving Loan Insurance Corporation (FSLIC) insurance fund to cover the losses of the member thrifts. This study begins with the year 1984; this is the first year that thrifts reported information on uninsured deposits and submitted quarterly reports, rather than semi-annual reports. The study captures five years (1984–1988) when "zombie" thrifts were operating in a deregulated environment.

In 1989 the insolvency of the FSLIC was finally recognized and the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) dissolved the FSLIC and the Federal Home Loan Bank Board. Barth's (1991) Chapter 4 provides a good discussion of FIRREA. Supervisory authority was transferred to the new Office of Thrift Supervision in the Treasury Department and a new insurance fund (Savings Association Insurance Fund (SAIF)) was placed under the auspices of the FDIC. Insolvent thrifts were transferred to the Resolution Trust Corporation (RTC), a new agency overseen by the chairman of the FDIC and provided with additional funding to resolve the crisis. FIRREA provided asset restrictions on both federal and state chartered thrifts (limitations on commercial real estate lending and the Qualified Thrift Lender Test), increased capital requirements, and limited the acceptance of brokered deposits to adequately capitalized thrifts. Enforcement powers by regulators were increased. The procedures for removing deposit insurance or appointing a receiver or conservator were expedited. Thus there are reasons to believe that the increased regulatory discipline, after the passage of FIRREA, may encourage additional uninsured deposits and/or may be a substitute for depositors' reactions to the risk-taking activities of thrifts. Our period of study covers the five-year period, 1990 through 1994, to evaluate the effects of depositor discipline in the regulatory environment overseen by SAIF.

The FDIC Improvement Act (FDICIA), passed in late 1991, increased both regulatory and depositor discipline. FDICIA introduced prompt corrective action, limited the too-big-to-fail doctrine for big banks, and imposed stronger constraints on depository institutions' acceptance of brokered deposits (following FDICIA, adequately capitalized institutions must receive approval before accepting brokered deposits). It also introduced risk-based deposit insurance premiums. This study