



Daily Note: 14 October 2008

The end of deposit guarantees

WE SUGGEST: Safer banks mean less profitable banks

SUMMARY: The current model of deposit guarantees is clearly unsatisfactory. Governments want to avoid moral hazard and so do not, in normal times, guarantee all bank deposits. But, in a moment of crisis, all deposits (or most) are guaranteed. This system neither precludes runs on banks, nor avoids moral hazard. One possible way of squaring this circle is to force banks to fully back demand deposits. But this is a costly and profit-eroding measure.

There have already been many casualties of the financial crisis. But one potential casualty is not an institution but rather a concept. This is the concept of guaranteeing bank deposits. This has always been a somewhat questionable measure. On the one hand, it saves depositors' money and contributes to preventing runs on banks. On the other, it gives rise to the concept of 'moral hazard', enabling banks to take risks they otherwise might not take, in the knowledge that if they succeed, there is plenty of upside, while if they fail, the downside is limited and generally borne by someone else. There is, of course, also a moral hazard for the depositors as well. If their deposits are guaranteed, they are free to put their money in the highest-interest, but also most risky accounts, knowing that they have nothing to lose. For these reasons, governments have generally been wary of promising complete deposit guarantees.

However, one of the lessons from the current crisis is that such wariness falls by the wayside if there is a risk to deposits. Although the United States has 'only' raised the limits of its deposit guarantee from \$100,000 to \$250,000, governments elsewhere have hastened to promise to safeguard all deposits, most recently in Australia. This is perhaps not surprising; after all, if necessary to prevent possible bank runs, a promise that most likely will never have to be fulfilled is a cheap price. Moreover, depositors are not only depositors – they frequently also go by name 'voters', a category that governments spurn at their peril. Hence, deposit guarantees may be non-existent or limited – but only until needed, when they suddenly come into being or are widened. This is also the experience from previous financial crises, eg the Nordic one in the early 1990s, when Sweden went from no guarantee to guaranteeing all deposits.

This leaves policy makers and tax payers in the worst of all positions. Explicit deposit guarantees encourage irresponsible bank lending; their absence is not credible but can theoretically (Northern Rock) trigger a bank run before they are introduced. How can this circle be squared? One possibility would be to introduce a 100% reserve requirement for demand deposits. In other words, banks would have to have on hand, in their vaults (or with the central bank) funds to cover all possible immediate withdrawals. (This is a proposal that in the past has been advanced by eg Milton Friedman and Murray Rothbard.)

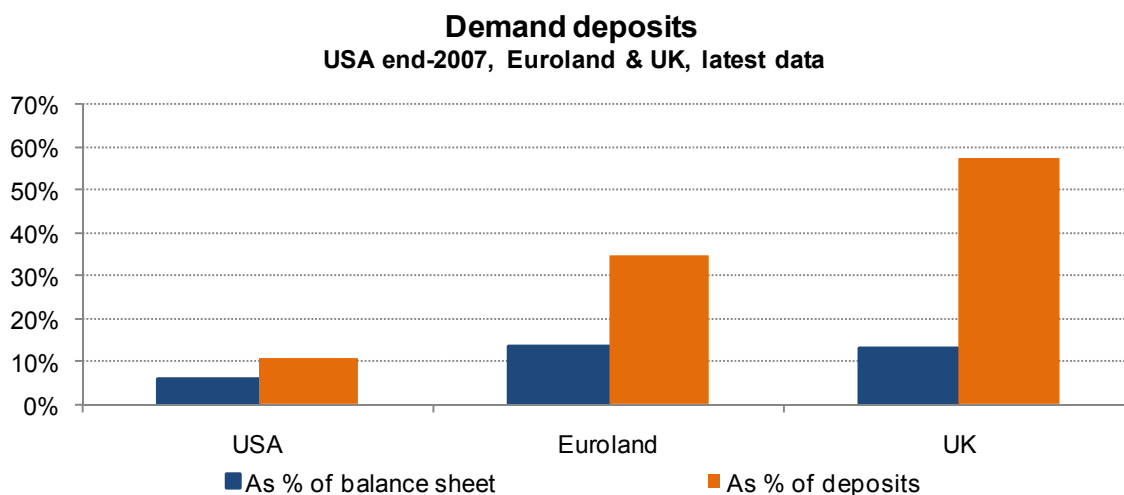
What would the impact of such a move be? For one thing, if banks have to maintain 100% reserves against demand deposits, they can lend that much less and their profits

will suffer accordingly. Looking at the United States as an example, demand deposits at commercial banks currently total some \$721bn (week ending 29th September). The average over the past year is \$610bn, but there was a surge in the two most recent weeks (see yesterday's *Daily Note. WaMu bedevils US broad money*). Other deposits total ten times as much, around \$6.5trn. For simplicity's sake, we will assume that the entire demand deposit reserve coverage will be extra to current required reserves. This means banks setting aside another \$610bn (to use the twelve-month average) which can now not be profitably employed.

The June 2008 Federal Reserve Bulletin article *Profits and Balance Sheet Developments in U.S. Commercial Banks in 2007* shows that banks' return on assets over the past 25 years never has exceeded 1.4% and generally been lower (ranging from nothing in 1987 to close to 1.4% in 2006). Let us generously assume a 1.4% return. This means that the profit foregone on \$610bn is \$8.5bn. In fact, the profit foregone would probably be higher, since the interest on demand deposits tends to be very low and so banks' margin on lending out those funds is correspondingly higher. But this is not possible to quantify.

US commercial banks' income before taxes and extraordinary items amounted to 1.41% of net consolidated assets in 2007 (down from 2% in 2006). With average net consolidated assets at \$10.4trn, this means profits of \$145.5bn. A profit foregone of around \$8.5bn is thus noticeable but hardly crippling.

The profit foregone might well be less. If banks were forced to fully back demand deposits, they would most likely react by increasing the difference between the remuneration on demand deposits and time deposits, making the latter relatively more attractive. Again, this is impossible to quantify at the moment.



Performing the same calculation for Euroland banks is more difficult. For one thing, the only pan-Euroland data on bank balance sheets and profits is Eurostat's sectoral financial accounts. These only show the financial sector, which is wider than just MFIs (banks). But there are reasons to expect that the initial impact of 100% backing for demand deposits would be greater on euro-zone banks than on American. Overnight deposits (which we assume to be the same as demand deposits) in Euroland total €3.2trn (August 2008). By comparison, other deposits total €5.9trn (including €2trn of longer-term deposits (with agreed maturity in excess of two years or redeemable at notice in excess of three months). Even if Euroland banks' profit margins are lower

than American (the financial sector data referred to above gives returns on assets of 0.7%, but the figure for the actual banking sector can of course be quite different), setting aside more than three trillion euros would be a major hit to bank profits. Again, of course, one can assume that Eurozone banks would do their best to shift deposits from demand to time accounts.

Finally, looking at the UK, total sight deposits in August this year amounted to £966.5bn, with time deposits £1.164bn, ie, an even narrower balance between demand and time deposits than in the euro-zone. Pre-tax profits of the major banking groups totalled £31.9bn in 2007, equivalent to a return on assets of slightly less than 1.1%. Implementing a 100% backing for demand deposits would thus imply a profit foregone of about £10bn – close to one-third of total profits (with such caveats as noted above under the US calculation). This is obviously not going to happen.

Does this mean that 100% backing for demand deposits is unrealistic? Not necessarily. But it does mean that its introduction would take substantial preparation in order to avoid eroding banks' profits. That being said, is it realistic to expect such a move? Banks would obviously fight it tooth and nail. So far, no one (as far as I know) has suggested the idea. But the problem of deposit guarantees and moral hazard does somehow have to be solved. The credit crunch has shown that current (or rather, recent) arrangements are unsatisfactory. 100% backing for demand deposits is one possible way forward.

Gabriel Stein

gabriel.stein@lombardstreetresearch.com