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The Case for Saver Insurance

It is Saturday night. You are walking towards the giant chromed door of your local cinema. Suddenly a young woman bursts out. “Fire, Fire” she yells. You do not stop to ask: is there a conflagration or are you shouting to distant friends the name of that nice restaurant in central Dublin? No. You run. And you are sensible to do so. The gains from being right are enormous; the costs of being wrong are tiny. This is not the time to consult either the lady or the Irish Good Food Guide.

There, in a nutshell, is the problem for our banking system – and indeed the world’s. When there is a rumour of problems at Bank Solid, there is an almost overwhelming case for going there today and getting your money out. Herd behaviour gets a bad press, but for millions of years it has stood us in excellent stead. The biologist WD Hamilton explained in a 1971 article that although a herd has the appearance of being one organism it is not necessary to draw on deities or group theories to explain that. He showed with mathematics that animals, when attacked, will optimally cluster into a churning, running flock as each aims to be on the interior of the moving pack so as to avoid being the one snatched up in the jaws of the predator.

It is immoral to let savers lose their money. Yet runs can be rational. Because they lend for a living, banks are different from other commercial enterprises. The only cast-iron way to prevent bank runs is to offer a cast-iron guarantee to savers.

What should we do in western society to cope with possible bank collapses, and can we find some compromise between the inefficiencies of heavy regulation and the dangers of untrammelled market crashes? The answer is the following. As with car crashes, we must devise an effective insurance solution in which governments are only minimally involved.

First, when they open an account, every bank depositor should be offered insurance deals that, for different levels of premium, would guarantee different amounts of their funds. Savers who wish for complete security will then get that in return for a high premium. Those slightly less worried will accept, as in the case of motor insurance, and in exchange for a smaller premium, a larger ‘excess’, where in the event of a bank collapse they forgo the first X hundred pounds of their savings.

Second, no government payouts should be promised or made to unfortunate savers -- nor any payouts to the investors with shares in financial institutions. They must all take their chances. Otherwise, there will always be a temptation, as now, for politicians to make speeches emphasizing the need for enormous safety margins to be maintained by commercial banks. Such margins would minimize the chance of voters later complaining to their local MP. But they would not be in the interests of efficiency.

Third, this kind of saver insurance would be sold by large institutions with assets spread widely enough, across many nations, to survive even major financial shocks within a single country. The global insurance industry is unavoidably hurt by extreme events like the September 11 World Trade Centre aeroplanes and the 2004 tsunami. Yet it can survive. Moreover, those insurance companies are better placed than government inspectors to keep an expert eye on any profligate lending practices inside banks.

Could not government regulation achieve the same without any need for insurance premiums and market capitalism? It could not. Banks make their money by providing loans, so it is not feasible for a government to stipulate a reserve requirement rule that would absolutely guarantee depositors complete safety: there is an inherent trade-off between risk and return. Very occasionally, might financial shocks be so widespread across the world that even giant international insurance companies would be threatened? Maybe, but this, if it ever arose, would cause problems under any arrangement. It would have to be faced if and when it happened.

The Bank of England has been criticized for handing a bailing bowl to the sinking Northern Rock, and similar hostility is being directed at the US Federal Reserve for its encouragement of a buyout of failing Bear Sterns. Both criticisms are misplaced. Without the existence of private compensation for depositors, the Old Lady and the Fed had little option. That is why we need proper saver insurance.