Bank Failures: 127 Down, 800 to Go

When Zacks Equity Research announced on Monday the failure of two more banks in the current recession, the silence was deafening. The report blamed the usual suspects: “tumbling home prices, soaring loan defaults, and a high unemployment rate continue to take their toll on such institutions.”

But buried in the report was the much more ominous forecast of the “increasing … possibility of more bank failures.” Zacks said that any bank which makes the FDIC’s problem bank list is essentially doomed. “As of now, only 13 percent of banks on [that list] have actually failed.” The number on that list? 829, up from 775 in the last quarter.

The FDIC, the quasi-insurance fund that looks like private insurance but enjoys all the benefits of government (i.e., taxpayer at risk) guarantees, is already deep under water, with its present deficit of over $15 billion, and counting. In the conclusion of its report, Zacks said that “increasing loan losses on commercial real estate are expected to cause hundreds more bank failures…. The FDIC expects [those] failures to cost about $60 billion [just] over the next four years.”

Dan Fitzpatrick, writing for SmartMoney, said that the number of U.S. banks could drop by a third, from just under 8,000 at present, to barely 5,000 survivors. And the impact is huge: 188,000 jobs in the financial sector have already been lost, and the decline in available capital for loans has been staggering. Howard Headlee, president of the Utah Bankers Association, said:

> When we step back and look at this financial disaster 10 years from now, the destruction of capital in our economy as a result of what we’ve endured will be the single greatest lasting impact on recovery and how the economy performs in the future.

And some economists think the FDIC is actually slowing the necessary cleansing process. Says economist Edward Yardeni, “I don’t think enough banks have failed, or have been failing fast enough, to have a macro-economic impact.” The impact of the TARP bailouts of the big banks, however, has been impressive. Bank of America, J.P. Morgan Chase & Co. and Wells Fargo now hold *one-third of all bank deposits in the country*, up from 21 percent just four years ago. And this gives them enormous leverage over the smaller banks who continue to fight not only the awful economy but increased financial regulations. John Squires, who was the CEO of Old Southern Bank when it failed in March, said that his competitors survived because of government bailouts. He considers it “absolutely unfair — the big boys have the clout. Community banks [like ours] are in jeopardy all over the country.”

The FDIC was a creation of the 1930s when, during the Great Depression, more than 5,000 banks failed. In fact, just four days into his first term, President Franklin Roosevelt was asked about providing government guarantees for failing banks, and he said no:

> I can tell you as to guaranteeing bank deposits my own views, and I think those of the old [Hoover] administration. The general underlying thought behind the use of the word "guarantee" with respect to bank deposits is that you guarantee bad banks as well as good banks. The minute the Government starts to do that the Government runs into a probable loss…. We do not wish to make the United States Government liable for the mistakes and errors of individual banks, and put a premium on unsound banking in the future.

FDR was right, of course, but signed the FDIC bill into law in 1934. As Warren Gibson wrote in *The Freeman*, federal government deposit insurance "guarantees moral hazard: an incentive to engage in more reckless behavior when one's misdeeds are covered by someone else." That's why the free market and private deposit insurance, left to their own devices, would provide ways to limit risky behavior by banks through the use of deductibles, co pays, threats of cancellation of coverage, and rewards for prudent behavior. The trouble with the FDIC is that it is part of a "monopoly supplier to banks" which makes it subject to political influence. For instance, when Congress voted to increase the FDIC insurance limit on deposits from $100,000 to $250,000, there was little if any discussion of the costs involved. That "temporary" increase in coverage has now been made permanent. Gibson is a realist:

> Make no mistake, our current banking system is, and has long been, a cartel run for the mutual benefit of Wall Street financiers and their regulatory friends in Washington….

Let us not be so naive as to believe that government deposit insurance is any different. Any benefit this system provides to small depositors is incidental to its real objective: to serve the cartel.