Lessons from the Rhode Island Banking Crisis

Thomas E. Pulkkinen and Eric S. Rosengren

Manager, Monitoring Department, and Vice President and Economist, Research Department, respectively, Federal Reserve Bank of Boston. *The authors would like to thank Robert J. Chicoski, Patricia C. Cosgel, and Kristin R. Kiel for valuable research assistance.*

On January 1, 1991, the newly inaugurated governor of Rhode Island announced the closure of 45 credit unions, banks, and loan and investment companies insured by the Rhode Island Share and Deposit Indemnity Corporation, a private insurance fund. The closing of the 45 depository institutions froze the accounts of 300,000 depositors, directly affecting roughly one in three residents of Rhode Island. Furthermore, the closure froze 10 percent of all deposits in Rhode Island depository institutions, an unusually high percentage of bank deposits in a particular region, seriously disrupting transactions of businesses and individuals alike.

The failure of the Rhode Island Share and Deposit Indemnity Corporation (RISDIC) was preceded by the highly publicized failures of private insurance funds in Ohio and Maryland during the mid 1980s. Many of the mistakes contributing to the failures of these other insurers were also made in Rhode Island. Several features of RISDIC were particularly threatening to its long-run viability, however.

First, both RISDIC and the insured depository institutions had significant concentrations of risk. The insurer covered deposits in a small geographic area, exposing the RISDIC fund to substantial risk from a regional economic downturn. A parallel structural shortcoming was the small size of the RISDIC fund, which made it unable to sustain the failure of even one of its largest insured institutions. Similarly, the insured institutions had substantial concentrations in real estate lending, making them particularly susceptible to a downturn in that sector.

Second, the insurer was run by the insured members, fostering conflicts of interest between RISDIC actions in support of the ongoing safety and soundness of the insurance fund and decisions beneficial to the profitability of the RISDIC members. Management of the insured institutions constituted a substantial majority of the RISDIC board of directors, and in fact the board could be legally constituted without any outside directors at all.

Third, the regulatory design of RISDIC was inadequate, and the private insurer disregarded many of the principles practiced by federal regulators of depository institutions. RISDIC examiners were accountable to a board composed of officials from the examined institutions. In addition, RISDIC and its insured institutions had not effectively implemented either the standard practices promulgated by the National Association of Share Insurance Corporations and adopted by RISDIC in 1985 or the operating standards required of credit unions and banks supervised by federal agencies.

The first section of this article provides a brief chronology of events. The second describes the problems that contributed to the RISDIC failure. The third section describes the effects of the Rhode Island banking crisis on other private insurance funds and on government policy. The final section summarizes lessons to be drawn for private insurance from the RISDIC crisis.

I. Chronology of Events

RISDIC was chartered by the Rhode Island General Assembly and began operation in 1971 as a private nonprofit insurance company. Its initial purpose was to provide insurance for credit unions chartered in Rhode Island. At first, the membership was limited mostly to small institutions, with total deposits in 1972 of $134 million distributed over 40 institutions. Both the number of institutions and the total deposits in these institutions gradually increased, partly as a result of legislation enacted in 1976 that allowed RISDIC to insure financial institutions other than credit unions and a 1977 law requiring insurance for all depository institutions. By 1980 RISDIC insured $761 million in deposits, slightly more than a 300 percent increase in real dollars from 1972, at 78 institutions.

RISDIC's responsibilities grew with its membership. In 1980, legislation permitted the Rhode Island Department of Business Regulation (DBR) to accept RISDIC examinations.[1] Because of limited hiring by DBR as a result of austere state budgets, by the late 1980s DBR increasingly relied on RISDIC personnel to conduct depository examinations. This decreased the objectivity and effectiveness of the supervisory process by placing the management of the examined companies in charge of what should have been an independent review function.[2] In addition, insurance coverage was increased by RISDIC over time, rising from the initial maximum coverage of $40,000 per account to $100,000, consistent with the increase in federal limits. The ceiling was raised further in 1985, when RISDIC adopted rules to provide insurance up to $500,000 and to provide unlimited coverage on specific accounts.

The desire to extend insurance coverage to larger accounts and to a more diverse group of institutions was, in part, an attempt to compensate for a shift to federal insurance coverage by the stronger RISDIC-insured institutions. The exodus to federal insurance was accelerated by the failure of private insurance funds in Ohio and Maryland in early 1985. While the Rhode Island legislature did not enact the 1986 bill filed by the governor that would have required federal insurance for all RISDIC institutions, nine of the 22 largest RISDIC-insured institutions nonetheless became federally insured, leaving behind mostly small or weak institutions. Two-thirds of the remaining large RISDIC-insured institutions ultimately were unable to obtain federal insurance.

The defections of the strongest companies to the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Association (NCUA), as well as mergers, caused the number of RISDIC-insured institutions to fall to a low of 46 institutions by 1989. Despite this decrease in the number of institutions, a rapid expansion of deposits in the large, weak institutions that remained in RISDIC

The Rhode Island Attorney General, federal banking regulators, and others privately counseled Rhode Island government officials on the perils of RISDIC as early as 1985 and 1986.

[1] This was not intended to alter the substance of exams. The standards of RISDIC and of the DBR were compatible and many of RISDIC's examiners were former DBR staff.

[2] In reality, while the RISDIC board bore responsibility for an examination function essential to the safety and soundness of the insurance fund, information on examination results remained with RISDIC staff and was not generally reviewed by the board. However, the results were sent to the DBR.

resulted in a 40 percent increase, in real dollars, from 1980 to 1989.

While the Rhode Island Attorney General, federal banking regulators, and others privately counseled Rhode Island government officials on the perils of RISDIC as early as 1985 and 1986, the inherent vulnerability of the small insurance fund came to the fore as a result of a series of events starting at the beginning of 1990. In February, the DBR ordered that remedial action be taken to correct the unsound funding of fraudulent leases at Jefferson Loan and Investment Company that RISDIC examiners had observed developing over the course of two years. Jefferson failed in July 1990 at considerable cost to RISDIC and was reconstituted as Banner Loan and Investment Company, a subsidiary of RISDIC-insured Marquette Credit Union. That same month, RISDIC began an examination of Heritage Loan and Investment Company. By October, after DBR became involved in the examination, it was apparent that as a result of widespread fraud and embezzlement, Heritage was insolvent. RISDIC took control of Heritage and injected $17.5 million of insurance fund money into the institution. As the investigation of Heritage's problems intensified, its chairman fled the state and depositors began a run that RISDIC did not have the resources to meet, resulting in Heritage's closure.

The losses from both Heritage Loan and Investment Company and Jefferson Loan and Investment Company drained liquid assets at the insurance fund, requiring RISDIC to assess members for additional premium payments to repay Heritage depositors and restore the insurance fund. Despite the additional assessment, depositors remained concerned about the viability of the insurance fund. Large depositor withdrawals occurred at several RISDIC-insured institutions. By December 31, 1990, Rhode Island Central Credit Union had exhausted its lines of credit and Rhode Island Credit Union League (RICUL),[3] a provider of liquidity for credit unions, was unwilling to provide further funds to the troubled, privately insured credit unions. Not having the resources to satisfy depositor demand for withdrawal, the RISDIC board of directors requested a state-appointed conservator for the insurance fund.

With RISDIC in receivership, the governor of Rhode Island announced that all 45 RISDIC-insured institutions would be closed on January 1, 1991. During 1991, 33 of the institutions either reopened with federal insurance, paid off their depositors, or became inactive. The remaining 12 institutions, including most of the largest, remained closed with depositor funds frozen throughout 1991. In February, legislation created the Depositors Economic Protection Corporation (DEPCO) to attend to the resolution of the closed institutions. Constitutional and legal questions concerning the creation of DEPCO delayed state action to take control of the failed institutions and provide partial restitution to depositors. Buoyed by favorable court rulings, DBR placed most of the remaining troubled depository institutions into receivership, and DEPCO issued revenue bonds to finance payouts to depositors.

The first payments (other than emergency withdrawals) to depositors of some of the closed institutions began in June 1991, six months after the closure of the institutions. Partial payouts to depositors are still continuing, financed in part by DEPCO bonds and by the sale of assets of the closed institutions.

Table 1 describes the current status of the RISDIC-insured members as of March 1993. Twenty-five of the 45 institutions initially closed had reopened with federal insurance, six had repaid depositors and been liquidated, two were nondepository institutions that had become inactive, five had been acquired by other financial institutions with financial assistance from DEPCO and one without, and six never reopened, with further payouts required as of March 1993.

Table 1
Resolution of RISDIC-Insured Institutions, March 1993

Status	Number of Institutions
Reopened in 1991 as independent companies with federal insurance	25
Nondepository institutions that became inactive	2
Repaid depositors in 1991	6
Acquired by Coventry Credit Union in 1991	1
Acquired by Northeast Savings in 1992	4
Acquired by First Bank and Trust in 1992	1
Never reopened, with partial payouts to depositors still required	6

Source: Monitoring Department, Federal Reserve Bank of Boston.

[3] RICUL is the main outside source of liquidity for federal and state-chartered credit unions in Rhode Island. RICUL extends lines of credit to member credit unions and provides other services such as check clearing. If RICUL did not have sufficient funds to honor all of its lines of credit, it had access to credit through the Central Liquidity Facility, which serves as the central bank and lender of last resort for credit unions.

II. Why Did RISDIC Fail?

From its very creation, RISDIC was susceptible to failure caused by exposure at its insured institutions. While the insurer appeared stable for almost two decades, several of its members were sufficiently large and weak to have caused its failure during that period. That RISDIC did not fail earlier was attributable to its political clout and its ability to mask severe financial difficulties within its underlying membership. While the triggering events for the RISDIC crisis were the closure of Jefferson and Heritage, the failure of the privately insured deposit system can be attributed to the design and management of the insurance and regulatory systems. This section highlights the deficiencies that made RISDIC prone to failure: the high concentration of risks for both the insurer and the insured, the insurer serving as an instrument of the insured, and inadequate regulatory and supervisory oversight.

From its very creation, RISDIC was susceptible to failure caused by exposure at its insured institutions.

Concentration of Risks

A major role of insurance is to spread the cost of a member's recovery from financial loss across a diverse membership whose losses are not all expected to occur at the same time. In this way an event that would pose a grave risk to any one member can be ameliorated with insurance, so that no single event devastates any of the insured. This basic premise of insurance was violated by RISDIC.

RISDIC was chartered to insure member financial institutions solely in the state of Rhode Island. However, the state is particularly ill-suited for this type of private insurance. It has a population of only 1 million, less than many cities in the United States, in an area of a little over 1,000 square miles. With a highly urbanized population and a concentration of manufacturing industries, few possibilities of achieving a diverse insurance pool are available.

Commercial insurers with undue exposure to a particular type of risk frequently limit exposure through reinsurance. This enables an insurer to shift risk too large for it to absorb, by reselling some of the exposure to other insurers. RISDIC had reinsurance until 1981, but it was discontinued when the policy was no longer sold by its private insurance company. It is unclear how actively RISDIC sought other reinsurance (though other private insurers did have reinsurance), but it certainly would have benefited from the reduced exposure.

Given the lack of diversification and the absence of reinsurance, it was important for RISDIC to reserve appropriately for exposure to problems at individual institutions.[4] Table 2 illustrates just how far RISDIC strayed from the principle of maintaining a large reserve relative to the potential risks from the failure of any one member. The insurance pool, which totaled $25 million in 1990, was inadequate to cover major losses at any of the 10 largest members of RISDIC. For Marquette, the largest member of RISDIC, losses equivalent to a payout of as little as 8 percent of total deposits would have been sufficient to exhaust the RISDIC fund. It should be noted that the RISDIC failure was triggered by the failures of Jefferson and Heritage, institutions with combined assets of only $39 million at the end of 1989, substantially less than those of any of the 10 largest RISDIC-insured institutions.

If an insurer has a large potential exposure to loss, it can spread risk by enrolling new insureds with low claim-making probabilities, or it can variably price its insurance coverage, substantially raising premiums for members with characteristics that increase the probability of making a claim. For example, some health insurers deny insurance to individuals with pre-existing health problems and deny coverage or charge higher premiums to individuals who smoke. RISDIC, however, behaved perversely for an insurance fund, encouraging membership by institutions that posed high risks to the fund and allowing riskier behavior without requiring higher premiums.

Start-up institutions with low capital, such as Pierbank and Heritage, received RISDIC insurance after failing to qualify for federal insurance. Greater Providence Deposit and Jefferson also sought RISDIC insurance as the insurer of last resort, as their finan-

[4] Appropriate reserving alone, however, could not have prevented the RISDIC failure, given the sizable risks and the limited funding sources available to RISDIC. Thus, even with more appropriate reserves, RISDIC was viable only if greater restrictions were placed on lending by member institutions.

Table 2
RISDIC Fund Exposure to the 10 Largest RISDIC-Insured Institutions, December 1989

RISDIC Member	Assets ($ Millions)	Deposits ($ Millions)	Deposit Payout Sufficient to Exhaust RISDIC Fund[a] (Percent)
1. Marquette Credit Union	344	311	8
2. Rhode Island Central Credit Union	262	231	11
3. Greater Providence Deposit Corporation	226	206	12
4. Davisville Credit Union	157	141	18
5. Pawtucket Credit Union	135	105	24
6. East Providence Credit Union	115	107	23
7. Rhode Island State Employee Credit Union	111	102	25
8. Union Deposit Loan and Investment Bank	111	100	25
9. Columbian Credit Union	91	85	29
10. Westerly Community Credit Union	68	59	42

[a]Based on $25 million fund in 1990.
Source: Rhode Island Department of Business Regulation, *Eighty-Third Annual Report of the Division of Banking*, 1990.

Table 3
Asset Categories of Depository Institutions, as of September 30, 1990 Statement of Condition

Institutions	Real Estate Loans as a Percent of Total Assets	Installment Loans as a Percent of Total Assets	Other Real Estate Owned (OREO) as a Percent of Total Assets
Ten Largest RISDIC-Insured	59.7	9.2	3.0
New England Commercial Banks			
FDIC-Insured	29.0	6.2	1.5
U.S. Credit Unions			
NCUA-Insured	21.9	42.0	.1

Source: Rhode Island Department of Business Regulation, Federal Reserve Board, National Credit Union Administration.

cial position would not qualify them for federal insurance. Despite their problems, these higher-risk companies paid no higher premiums than less risky institutions in the RISDIC pool.

RISDIC's limited ability, or proclivity, to garner sufficient loss reserves and thereby counteract insurance risk concentrations warranted the minimalization of risk by influencing the investment exposure of the insured institutions. Table 3 highlights the failure of RISDIC to control high-risk investment strategies of its members. The largest RISDIC-insured institutions were much more concentrated in real estate lending than were federally insured credit unions or commercial banks.[5]

While the real estate loans are not broken out in their call reports, internal documents indicated that a majority of the real estate loans held by the largest RISDIC-insured institutions were in categories generally considered risky (real estate loans other than one- to four-family residential mortgages). The risk is reflected in the percentage of loans transferred to other real estate owned (OREO) status, which represents foreclosed property. As of September 30, 1990, the largest RISDIC-insured institutions had 3 percent of their assets in OREO, compared to 1.5 percent for FDIC-insured commercial banks and only 0.1 percent for NCUA-insured credit unions. Allowing high concentrations in risky assets can be assumed to have been a conscious decision by RISDIC, since many types of loans held by RISDIC institutions were prohibited or limited by federal insurers of credit unions. RISDIC regulations were silent or less stringent than federal provisions about limits on lending to insiders and individual borrowers, for business

[5] While savings and loans and savings banks often have high levels of real estate lending relative to total loans, they are usually concentrated in one- to four-family mortgages.

Table 4
CAMEL Rating and Financial Status of the 10 Largest RISDIC-Insured Institutions, 1989–90

RISDIC Member	CAMEL Rating	Classified Assets as a Percent of Total Assets	Classified Assets as a Percent of Total Capital[a]
1. Marquette Credit Union	2	9.7	128.7
2. Rhode Island Central Credit Union	2	12.1	131.9
3. Greater Providence Deposit Corporation	4[b]	4.2	99.9
4. Davisville Credit Union	4	11.8	150.3
5. Pawtucket Credit Union	1[b]	n.a.	n.a.
6. East Providence Credit Union	2	3.4	58.8
7. Rhode Island State Employee Credit Union	2[b]	n.a.	n.a.
8. Union Deposit Loan and Investment Bank	1	1.9	16.6
9. Columbian Credit Union	3	8.5	130.0
10. Westerly Community Credit Union	1	n.a.	n.a.

[a]Capital includes loan loss reserve, equity, undivided earnings, and the funds held in RISDIC.
[b]Exam 1988.
n.a. = not available (institutions still in operation in 1993).
Source: CAMEL ratings taken from Vartan Gregorian, 1991, *Carved in Sand*, Report of Rhode Island Governor's Commission on the RISDIC Failure, March 14, Appendix 23. All ratings are for 1989–1990 unless otherwise noted. Classified ratios taken from Call Reports–9/30/90.

purposes and by type of credit. The RISDIC-insured institutions were heavily exposed to commercial real estate construction and land development projects, which contributed significantly to their ineligibility for federal insurance and ultimately to their failure.

Insurer Controlled by the Insured

A private insurer employs incentives to prevent the insured from engaging in particularly risky behavior. For example, life insurance frequently does not cover accidents resulting from parachuting, and homeowners policies often limit coverage of jewelry located in the home. RISDIC behaved quite differently, however, allowing or assuming risks greater than those assumed by other industry insurers. Allowing risky investments prohibited or curtailed by federal regulations, insuring deposits in excess of the federal limits, limiting the requirement for independent examinations, and paying large dividends on the insurance fund rather than increasing the insurance pool all benefited the insured institutions at the expense of the insurance fund.

This countenance of increased risk by the insurer to the benefit of the insureds' operating profitability can be tied to the structure of RISDIC. The board of directors consisted of 15 representatives of member institutions and could, but was not required to, include up to three outside directors. The inside members included representatives from most of the largest and most troubled institutions. Table 4 provides both the CAMEL rating (an examiner evaluation of banks, with 1 representing the strongest institution and 5 representing the weakest)[6] by the DBR, as reported in *Carved in Sand*, and classified asset ratios[7] for the 10 largest members of RISDIC. The four of these institutions with classified assets that exceeded 100 percent of capital (Davisville, Marquette, Rhode Island Central, and Columbian) were all represented on the board of directors of RISDIC.

An independent bank insurance system should properly manage and price risk, acting in a manner that assures the solvency of the insurance fund and the safety of customer deposits. This principle was clearly violated by RISDIC, which served as an advocate for many of its member institutions. Of the 15

[6] Banks are rated by examiners according to the condition of the capital adequacy, asset quality, management quality, earnings potential, and liquidity of the institution (CAMEL). One is the highest rating, indicating a strong, performing bank with no need for supervisory concern. Two indicates a stable and safe bank that can withstand a downturn in the economy. Three indicates a bank with a remote probability of failure that is nonetheless experiencing some difficulties. Four indicates a bank with potential for failure whose current performance could impair viability. Five indicates a bank with high probability of failure and critically deficient performance. Ratings can vary by regulator and in fact many of the institutions rated 2 by DBR were unable to qualify for federal insurance.

Table 5
Structure of Insurer

	National Credit Union Administration	Rhode Island Share and Deposit Indemnity Corporation
Board Composition	3 appointed government officials	18 members (3 outside members and 15 CEOs of member institutions)
Audits	Inspector General Semiannual reports to Congress	Outside auditor Department of Business Regulation
Reserve	Deposit 1 percent of insured shares	Deposit 1 percent of insured shares
Premium	One-twelfth of 1 percent of insured shares	One-twelfth of 1 percent of insured shares
Coverage	Maximum $100,000	Unlimited with RISDIC Board approval

RISDIC members of the Board of Directors as of April 1990, eight were representatives from institutions that failed to get federal insurance and represented over 60 percent of RISDIC-insured deposits. RISDIC's operational decisions were made by a five-member executive committee. Included on this committee were representatives of three of the more troubled institutions: the chairman of Heritage, who later fled the state; the chairman of Rhode Island Central Credit Union, the first company to become illiquid as a result of deposit withdrawals during the banking crisis; and the Chairman of Providence Teachers, which also failed to obtain federal insurance.

Having the management of troubled institutions in a position to influence the operation of the insurance and supervisory functions compromised the efficacy of the RISDIC insurance system, and meant that the interests of the insurer and of the depositors were not assured of receiving appropriate consideration. The closed circle of RISDIC officials, both elected and appointed, were beholden to the leaders of the troubled credit unions. The absence of an effective external audit and oversight process facilitated the continued operation of the insurance fund and its weak members. Over long periods during the 1970s and 1980s, RISDIC provided extended and undisclosed assistance to a large troubled institution, Marquette Credit Union, which because of its size was critical to the survival of RISDIC. The resolution of any one of the large, troubled insured institutions could have rendered the insurance fund insolvent, thereby subjecting all the weakened institutions to possible closure, as many would not have qualified for federal insurance.

[7] Loans are classified by bank management and examiners based upon the probability of the bank incurring losses. Classifications range from substandard loans (which pose some exposure to loss if conditions are not corrected) to doubtful (where collection or liquidation of the full balance is improbable) to loss (where the loans are considered uncollectible and should be charged off as loan losses).

Regulatory Design

Table 5 compares the structure and insurance provisions of RISDIC with those of the National Credit Union Administration (NCUA), the federal insurer of credit unions. While the two insurers have several similarities, they also have critical differences, the most significant being the degree of oversight of the two insurance funds. The NCUA board members are appointed government officials, while RISDIC's board was large, and often dominated by troubled member institutions. While the NCUA had an internal inspector general, RISDIC relied on external audits by private auditors and the DBR. Although RISDIC had a external auditor, it switched accounting firms after the original auditor qualified its opinion, citing concerns with the potential losses should one of the larger member institutions fail.[8] This ability to replace the company that had expressed reservations about the insurance fund helped RISDIC keep problems from members' depositors and the DBR.

[8] The risks of a large failure were particularly acute because of the financial condition of Marquette Credit Union. Throughout the 1980s, RISDIC was providing assistance to Marquette. Because of its size, Marquette's survival was critical to the survival of RISDIC.

Institutions insured by RISDIC and NCUA were similarly required to maintain a deposit of 1 percent of insured shares and pay insurance premiums of one-twelfth of 1 percent of the value of insured shares. However, RISDIC often paid dividends to its member institutions of up to 50 percent of the insurance premium, while NCUA has never paid any dividends to its insured members. In addition, while NCUA limited its coverage to $100,000 per account, it was possible for RISDIC members to receive unlimited insurance coverage.

The governing and insurance structure of RISDIC exposed it to a somewhat greater insurance risk than that experienced by the NCUA. The RISDIC insurance fund was, however, far more exposed as a result of the risky lending opportunities allowed by RISDIC regulations, which made many of its institutions unable to qualify for NCUA insurance. RISDIC regulations were silent regarding appraisal standards and several other risk control measures critical to the safety and soundness of its members. They did not address loan limits with respect to insider relationships, concentrations by type of loan or to related borrowers, or collateral value limits, all areas that contributed to the failures of the members.

The riskier lending activities of the RISDIC-insured institutions and the substantial concentration of risk to which RISDIC itself was exposed demanded substantially better capitalization for RISDIC than was needed for the NCUA. The failure of RISDIC to appreciate the relationship between reserves and the proper management of insurance risk resulted in a significantly underreserved insurance fund.

In addition to insuring financial institutions, RISDIC also served as a bank supervisor and examined its member institutions. However, with most of the troubled institutions represented on the board of directors, RISDIC examiners had little incentive to aggressively pursue problem institutions. While the CAMEL acronym used for rating institutions was the same as for other federal regulators, the actual implementation was quite different. Despite having classified assets in excess of capital, both Marquette and Rhode Island Central had a CAMEL rating of 2, which should designate an institution that poses relatively little risk of failure.

Table 4 has provided the CAMEL rating of the 10 largest RISDIC-insured institutions and their levels of classified assets. Only three institutions had ratios of classified assets to capital low enough to qualify for federal insurance. For many of the other institutions, the CAMEL ratings provided little indication of the degree of their problems and their inability to qualify for federal insurance. A CAMEL rating of 2 usually designates fundamentally sound institutions that are stable and able to withstand normal business cycle fluctuations. Not only are 2-rated institutions considered to be in satisfactory condition, regulators consider 3-rated companies to have only a remote possibility of failure. Nevertheless, of the four 2-rated institutions listed in Table 4, only Rhode Island State Employees' Credit Union qualified for federal insurance; the other three did not. To give an example, Marquette's management was rated satisfactory or strong from 1986 until its failure, despite serious problems with Marquette's loan portfolio and the heavy, but undisclosed, RISDIC involvement in the operations of the credit union.

Even allowing for the poor state of the economy, the ultimate inability of these institutions to qualify for federal insurance indicates that the RISDIC and DBR examination process was unable to distinguish the extent of the underlying financial weakness of these institutions. This ineffectual examination function resulted from the absence of the necessary supervisory "clout," as demonstrated by a lack of appropriate support and follow-through on examiner concerns, inadequate budget resources, underpaid and inadequately trained staff, and the presence of conflicts of interest resulting in the management of insured companies unduly influencing the examination process.

III. RISDIC's Impact on Private Insurance and Government Policy

The RISDIC crisis had a major impact on private insurers of credit unions, many of whom were financially much healthier than RISDIC, as is shown in Table 6. In 1985, 13 private insurers provided insurance for 3,100 credit unions with $18 billion in deposits. In addition, private insurance funds operated in Massachusetts for 196 state chartered savings and cooperative banks with over $16 billion in deposits.[9] By early 1993, private insurers provided primary deposit insurance for only 536 credit union member

[9] "Excess insurance" programs offered in Massachusetts by private deposit insurers have effectively protected depositors of failed savings and cooperative banks from incurring losses. The insurance risk covered by these insurance funds is far less than that of primary deposit insurers, and the supervision of these insured institutions is the responsibility of independent federal and state supervisors, not the insurers.

Table 6
Private Credit Union Insurers

	6/30/85	6/30/90	1993
Number of insurers continuing in operation	13	10	4
Number of insurers dissolving the fund or terminating primary deposit insurance	0	0	3
Number of privately insured member institutions	3,100	1,484	536
Value of deposits (billions)	$ 18.0	$ 20.8[a]	$ 7.5

[a]Assets rather than deposits were used.
Sources: Phone contacts with private insurers by Monitoring Department, Federal Reserve Bank of Boston.

institutions representing $7.5 billion in deposits, and many of these were in the process of converting to federal insurance.

Of the nine private insurers other than RISDIC operating when the Rhode Island crisis developed, five had members convert to federal insurance after the failure of RISDIC. The orderly resolution of many of these private insurers would indicate that they were financially much stronger than RISDIC. Despite the healthier financial position of many of these insurers, the movement away from private insurance is not surprising given the significant costs of the RISDIC failure. The movement away from small, localized insurance funds reflects the increasingly held belief that the dominant issues of risk dispersion and reserve adequacy can best be dealt with by a move to a national insurance system that has access to government support at times of systemic weakness.

The effect on Rhode Island of the loss of depositor access to frozen accounts for up to 18 months also was damaging. Consumers and businesses could not pay bills or purchase needed goods and services. This resulted in increased layoffs during what would have been difficult economic times even without the RISDIC crisis. In addition, Rhode Island taxpayers are left to cover the high financial cost of unwinding a collapsed insurance system.

Table 7 documents the costs to state taxpayers. DEPCO had $659 million ($680 million less $21 million other liabilities) in bondholder and depositor claims outstanding as of January 31, 1993, with maturities extending out nearly 30 years. Loans and foreclosed properties with a loan value of $395 million have been assumed by DEPCO from the failed institutions. These assets have a projected recovery value of only $225 million, a 44 percent discount that reflects the poor quality of the loans made by the RISDIC-insured financial institutions. A substantial amount of the $45 million due from the receivers of the closed credit unions represents the estimated recovery value of environmentally tainted properties on which RISDIC-insured companies had extended credit. Should DEPCO in fact receive $270 million for these properties and apply the proceeds entirely against depositor and bondholder claims, $389 million ($659 million less $270 million) in indebtedness would still remain.

The remaining DEPCO funds will be consumed in the disposition of troubled assets, the covering of

Table 7
Statement of Condition,[a] Depositors Economic Protection Corporation, January 31, 1993
(000)

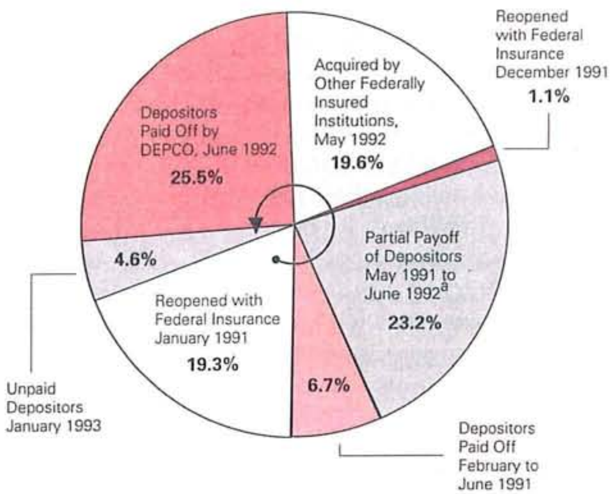
Loans and other real estate (net of reserve of $169,934)	$225,479	General obligation bonds	$ 511,753
Due from receiverships[b]	45,293	U.S. Treasury loan	74,299
Financing escrows, reserve and deferred finance costs	100,962	Guaranteed deposits	54,949
Other assets	45,810	Accrued interest payable	18,052
		Other liabilities	21,003
		Total indebtedness and other liabilities	$ 680,056
		Negative equity	(262,509)
Total Assets	$417,544	Total Liabilities and Equity	$ 417,547

[a]Column totals are not equal because of rounding.
[b]Primarily environmentally tainted properties.
Source: DEPCO unaudited balance sheet.

Figure 1

Rhode Island Banking Crisis
The Return of the Depositors' Money

Percent of Deposits Frozen on January 1, 1991



[a]Emergency withdrawals, and partial paybacks from institutions resolved in May and June 1992.
Source: R.I. Banking Department, *Providence Journal.*

any remaining exposure on loans sold to other financial institutions, and the financing of DEPCO indebtedness, as well as operating and litigation costs that could continue for several years. While court judgments and other settlements could reduce the ultimate cost of cleaning up after the RISDIC crisis, Rhode Island taxpayers will be paying the interest and principal on DEPCO's indebtedness for many years to come.

Figure 1 details the outcome of the deposits frozen at the outset of the RISDIC crisis. In the first month only 19.3 percent of the deposits became available from institutions reopening after qualifying for federal insurance. The bulk of the deposits were in larger institutions that were unable to obtain federal insurance because of their poor financial condition. While depositors could petition for emergency withdrawals, many of the deposits remained frozen until the failed institutions were sold or until DEPCO was able to make payouts. As of January 1993, only 4.6 percent of the deposits remained unpaid. Nonetheless, many businesses and individuals were seriously disrupted by having their deposits frozen for such an extended period.

IV. Conclusion

While private insurance schemes in Ohio and Maryland as well as Rhode Island were not successful, RISDIC assumed risks that made it particularly vulnerable. The insurer covered institutions in a small geographic area and troubled institutions that were substantially larger than its entire insurance pool. Insured institutions were allowed to take unusually risky positions in real estate development activities. Such an unstable situation was allowed to continue by the insurance fund's governing members, many of whom had incentives to remain unfettered by their insurer. While the regulatory structure loosely resembled that of the NCUA, the industry-controlled insurer provided little regulatory oversight and many member institutions were uninsurable under federal guidelines because of their concentrations of risk and their weak financial condition.

The conditions contributing to the RISDIC crisis highlight four ingredients necessary for a safe and sound deposit insurance system: the maintenance of a proper degree of risk aversion by the insured depository institutions; the presence of an effective, prospective-looking, independent supervisory function; the required public disclosure of material financial weaknesses and operating irregularities; and an appropriately reserved insurance fund.