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TESTIMONY

OF

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BEFORE THE

SUBCOMMITTEE ON

FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

OF THE

UNITED STATES HOUSE OF REPRESENTATIVES

JULY 26, 2001

Statement required by 12 U.S.C § 250

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman Bachus, Congresswoman Waters, and Members of the Subcommittee, I appreciate this opportunity to discuss reform of our Federal deposit insurance system. Too often reform occurs against the backdrop of a crisis. Fortunately, we are not in that position today. The deposit insurance funds and the banking industry are strong. Nonetheless, the flaws in the current deposit insurance system pose an unnecessary risk to the stability of the banking system and so merit a careful and timely review by the Congress.

For the past year-and-a-half, the Federal Deposit Insurance Corporation (FDIC) staff has engaged in an inclusive and thoughtful process to identify and analyze deficiencies in the deposit insurance system and to recommend solutions to those problems. A staff paper released by the FDIC in April 2001, and recent testimony by former FDIC Chairman Tanoue, identified what they believe to be four significant flaws in the existing deposit insurance system:

ŏ First, even though the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) provide an identical product--deposit insurance--for virtually identical institutions, the law requires the FDIC to administer the two as separate insurance funds, sacrificing both operating efficiencies and opportunities for risk diversification.

- Second, the current system of deposit insurance premiums does not adequately reflect the risk that individual depository institutions pose to the deposit insurance system. Currently 92 percent of all FDIC-insured institutions pay no deposit insurance premiums at all. More than 900 banks chartered within the last five years have never paid any deposit insurance premiums. The FDIC's inability to price deposit insurance according to risk results in a "free ride" for riskier banks, distorts management incentives to limit risks, and increases the moral hazard to the funds. It results in less risky banks effectively subsidizing the activities of riskier banks--the exact opposite of what was intended by the legislation that mandated a Federal risk-based deposit insurance system.

- Third, deposit insurance may be "procyclical." Under the present system, when a deposit insurance fund falls below its designated reserve ratio (DRR) of 1.25 percent of insured deposits, the FDIC must raise premiums sufficiently to bring the reserve ratio back to 1.25 percent within a year. If that cannot be done, it must charge every bank a premium of at least 23 basis points of its total domestic deposits until the reserve ratio reaches 1.25 percent. Thus, if an economic downturn leads to a decline in insurance fund reserves, banks could face dramatically higher deposit insurance premiums at the very time that bank earnings and capital are under pressure.

- Fourth, the FDIC staff paper observes that the real value of the level of deposit insurance coverage, set in 1980 at $100,000 per account, has not kept pace with changes in the price level over the past 20 years. Those who seek a safe repository for their savings can offset this reduced coverage in a number of ways. They can, for example, open multiple accounts at a single institution or accounts at multiple institutions. Nonetheless, some banks have argued for an increase in the current coverage limit and the adoption of a framework for periodically adjusting the level of deposit insurance coverage.

There are also several other issues that should be considered in the context of deposit insurance reform. These include the appropriate size of the insurance fund, the desirability of having a fixed designated reserve ratio, and the prospect of issuing rebates when the size of the funds exceeds a specified limit.

The OCC strongly believes that one further set of issues should be considered in this connection. That is the use of the insurance fund to support the cost of bank supervision, and the inequitable treatment of national banks in the way the BIF is currently used to pay the costs of supervision of state nonmember banks.

In my testimony, I review a series of recommendations that I believe will strengthen the insurance fund while reducing the inherent cross subsidization and distortions that arise among institutions under the current deposit insurance system.

Merger of the Insurance Funds

Currently, the FDIC administers the BIF and the SAIF separately. The OCC recommends that the BIF and SAIF be merged. A merged fund would enable the FDIC to operate more efficiently and to realize the benefits of diversification.

The maintenance of separate deposit insurance funds is a historical anomaly that traces its roots back to the 1930s, when the FDIC and the Federal Savings and Loan Insurance Corporation (FSLIC) were created in separate acts of Congress. When the FSLIC was abolished in 1989, and its functions were taken over by the FDIC, there were significant differences in the powers of commercial banks and thrifts. The thrift industry was just emerging from a period of extraordinary problems, and the risk profiles of banks and thrifts differed significantly. Over time, however, those differences have diminished. Significant commingling of the insurance funds, in the form of SAIF-insured deposits held by BIF members and BIF-insured deposits held by SAIF members, has further blurred the distinctions between BIF and SAIF. As of March 31, 2001, 874 banks and thrifts were members of one fund, yet held deposits insured by the other fund. BIF-member institutions held 41 percent of SAIF-insured deposits.

Industry consolidation has led to an increased concentration of insured deposits in relatively few institutions, which increases the risks to the deposit insurance funds. According to the FDIC staff, the share of SAIF-insured deposits held by the three largest institutions increased from 8.7 percent to 15.5 percent between June 1990 and March

2001, while the corresponding share for BIF-insured deposits increased from 5 percent to 13.7 percent. Merging the funds would reduce these concentration risks; for a merged fund, the share of deposits held by the three largest institutions would have been 12.4 percent.

A combined fund would also have better geographic and product diversification. Although the portfolios of banks and thrifts have become more similar in recent years, thrifts are still more highly concentrated in single family mortgages, while banks hold much higher percentages of commercial loans.

Pricing Deposit Insurance

In 1991, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) mandated a risk-based premium system and maintenance of required reserve levels, while providing the FDIC broad discretion to implement these goals. Five years later, the Deposit Insurance Funds Act of 1996 (DIFA) eliminated the FDIC's discretion. DIFA mandated zero premiums for banks in the lowest risk category when the fund equals or exceeds 1.25 percent of insured deposits. Further, it required the FDIC to charge a premium of at least 23 basis points on total domestic deposits when the fund falls below 1.25 percent for more than one year. The result is a pay-as-you-go system in which losses are determined after the fact and survivors are required to pay for the losses incurred in resolving insolvent institutions. Thus, while the size of the fund remains relatively stable, insurance premiums faced by individual banks can be extremely variable, regardless of the risk these banks present. Currently, the vast majority of banks and thrifts pay nothing for deposit insurance.

The OCC concurs with the FDIC staff's recommendation to eliminate the constraints introduced by DIFA on the FDIC's ability to set premiums, particularly the mandated zero premiums for banks in the lowest risk category whenever the insurance fund reserve ratio equals or exceeds 1.25 percent of insured deposits. The OCC further supports the FDIC exploring revisions to the deposit premium structure to improve the actuarial accuracy of the differential premiums paid by banks with different risk profiles. This does not necessarily mean that there is a need for a dramatically new and more complex approach to setting premiums. Even within the context of the FDIC's current matrix of premiums, we believe there are opportunities to make premiums more risk sensitive.

Under the current deposit insurance premium structure, 92 percent of banks (those that are well-capitalized with CAMELS 1 or 2 ratings) pay the same deposit insurance premiums. The risks those banks pose to the insurance funds, however, can vary greatly.[1] That these banks currently pay nothing for deposit insurance is even more troubling. The net result is a pricing system that has severed almost completely any connection between risk and the price of deposit insurance. To maintain a proper incentive structure and to compensate the government for the benefits conferred by deposit insurance on all banks,

[1] The FDIC staff noted in its Deposit Insurance Reform Options paper that "the 5-year failure rate for CAMELS 2-rated institutions since 1984 was more than two-and-a-half times the failure rate for 1-rated institutions."

even the least risky banks should pay some reasonable minimum insurance premium, regardless of the level of the fund.

Any effort to reform the pricing of deposit insurance should consider the appropriate range of insurance premiums. The premium structure initially adopted by the FDIC under FDICIA, which charged banks in the highest risk category 31 basis points on domestic deposits, seems to have taken into account factors other than risk, including the likelihood that weaker banks would be unable to afford higher premiums. During the banking crisis of the early 1990s, however, the spread between the yields on the debt of the most and least risky banks was at times as much as 700 basis points. While we would not suggest that deposit insurance premiums should exhibit as broad a range as market prices for bank debt, we note that in the current environment spreads on subordinated debt can be as much as 150 basis points among banks that today pay no insurance premiums.

There are, of course, challenges to improving the risk-sensitivity of deposit insurance premiums. Nonetheless, I believe it would be desirable to move incrementally, recognizing that perfection is not the relevant standard. Although measuring risk is an inexact science, I believe that, with the removal of some of the statutory constraints on pricing, the FDIC could implement in a reasonable time a risk-based system that improves significantly upon the existing system.

The Size of the Fund, Rebates and Surcharges

Determining the appropriate size of the insurance funds and deciding when and how to pay rebates or impose surcharges if the funds get too large or too small, are two of the most important issues in deposit insurance reform. The current system is flawed in that the current designated reserve ratio of 1.25 percent of insured deposits has no clear actuarial basis--that is, it has no particular relationship to the risks borne by the funds. Rather, it is based on the actual range of the reserve ratio in the 1960s and 1970s. Recent experience would support consideration of a higher level, although we would prefer that there be no statutorily fixed ratios.

The OCC strongly supports eliminating the current DRR of 1.25 percent. We favor empowering the FDIC to establish a size range for the fund, based on the FDIC's evaluation of the risks borne by the funds and its assessment of potential losses. The FDIC should have the flexibility to adjust that range as the health of the banking system and the risks to the fund change through time. In this context we would support authority for the FDIC to pay rebates when the upper end of the range is exceeded and to impose surcharges when the ratio falls below the lower end of the range. We also believe that the FDIC should have the discretion in addressing the need for surcharges, to take into account the effect such surcharges might have on the performance or health of the banking system. As a corollary, in order to mitigate the procyclical effects of increasing premiums in times of stress, the appropriateness of maintaining a strongly capitalized fund in good times should be recognized.

With the introduction of minimum deposit insurance premiums, it is likely that reserve balances in the funds will periodically exceed the upper end of the target range for the reserve ratios. As a result, it may be appropriate for the funds to pay rebates to insured institutions. To ensure that rebates paid to insured institutions are equitable, it is first necessary to consider the nature of insured institutions' claims on the funds. For instance, institutions that have paid little, if anything, into the funds may have a lesser claim on any rebates compared with institutions that have contributed to building up the funds.

To preserve the integrity of risk-based premiums, rebates to individual banks should be based on a factor that is unrelated to their current premiums. In other words, high-risk banks that pay large premiums should not receive higher rebates per dollar of insured deposits than banks that pose a low risk to the fund. One approach to the calculation of rebates would be to base the rebates on past levels of domestic deposits on which a bank paid premiums.

Any program of rebates should also reflect the benefits that are presently received by FDIC-supervised state nonmember banks in the form of cost-free supervision and examination. Under the current system of bank supervision, the FDIC covers its costs of operations out of the BIF and SAIF. The FDIC spends approximately $600 million dollars a year to supervise state nonmember banks--that is, to perform for state banks exactly those functions the OCC performs for national banks. None of these costs is passed on to state banks in the form of direct assessments. By contrast, the OCC charges national banks for the full cost of their supervision.

This disparity is compounded by the fact that more than half of the funds spent by the FDIC for Federal supervision of state nonmember banks are attributable directly to the accumulated contributions of national banks to the BIF. The earnings of the insurance funds--provided by all banks--finance the supervisory costs of only a portion of the banking industry. In other words, for every dollar the FDIC spends on the supervision of state banks, national banks, by our estimates, effectively contribute about 55 cents.

A key principle at the heart of deposit insurance reform is that the premiums paid by individual institutions should be closely related to the expected costs they impose on the funds. The objective is to identify and eliminate subsidies in the current system that can distort decision making. As the FDIC staff notes in its arguments for a risk-based pricing system, healthy, well-managed banks should not be required to bear the costs and risks presented by less well-managed, riskier banks. Similarly, banking supervision should not be based on a system of subsidies--such as those embedded in the current deposit insurance system--that results in national banks paying a substantial portion of the FDIC’s cost of supervising state banks. As a matter of equity among banks, regardless of charter, the OCC believes that reform of our system of deposit insurance should recognize that the *current* system requires that national banks cover a significant portion of the cost of supervising state nonmember banks. Because one of the main purposes of bank supervision is to protect the insurance fund, ensuring that supervision is funded in a fair and equitable manner is inextricably related to the subject of deposit insurance reform.

Attached to my testimony is a paper that discusses the disparity in funding supervision in greater detail and proposes a legislative remedy. Our proposal recognizes that effective supervision is a critical component of a sound deposit insurance system. Because the FDIC insurance fund currently funds Federal supervision of state nonmember banks, we believe that it would make sense to extend the existing arrangement to cover the costs of both state and national bank supervision from the FDIC fund. In other words, instead of funding supervision through direct assessments on banks, we propose that it be funded by payments to supervisors--the OCC and state supervisors--from the insurance fund, to which all banks contribute. This approach would strengthen both Federal and state supervision by ensuring that all supervisors have adequate, predictable resources available to carry out effective supervisory programs.

Coverage Limits

The erosion of the real value of the nominal deposit insurance coverage limit by inflation since 1980 has generated proposals to increase the coverage limit from its current level of $100,000 per account. Opponents of such an increase argue that it is not needed and that it would increase the exposure of the funds and would reduce market discipline.

While this is clearly an issue that deserves consideration by the Congress, the OCC is concerned that an increase in coverage might have unintended effects that most would judge to be undesirable, including an increase in moral hazard. We are fortunate today to have a very strong banking industry, but conditions may not always be so positive. Increasing deposit insurance coverage effectively allows weaker institutions to expand their risk-taking at a time when they should be retrenching--a lesson that we learned painfully during the savings and loan crisis. Increasing deposit insurance coverage also raises the cost to the insurance funds in the event of a bank failure. Reducing the risk of loss for large depositors may undermine market discipline and result in a haphazard reshuffling of existing deposits. We are not persuaded that an increase in coverage is necessary for deposit insurance to fulfill its purposes of preventing depositor runs on banks and providing a basic level of risk-free protection for depositors. Nor have we seen compelling evidence that depositors are demanding increased coverage.

The simple fact is that anyone who wants to use insured bank deposits as a means of holding their wealth can do so today virtually without limits--subject only to the inconvenience of having to open accounts at multiple banks. Of course, one may argue that, because of the relative ineffectiveness of the existing coverage limit, an increase may not have any substantial adverse consequences. But, it is precisely because of the dangers that attend legislating in the presence of uncertainty that the OCC would favor a cautious approach in this area.

The lack of consumer demand for increased deposit insurance coverage is evidenced by the fact that, despite the ability of depositors to achieve virtually unlimited coverage, there is over $1 trillion of uninsured deposits in the banking system, compared with over $3 trillion in insured deposits. This does not suggest, however, that large numbers of Americans are adversely affected by the existing coverage limit; the Federal Reserve's 1998 Survey of Consumer Finances reported that 98.0 percent of all households that held any deposits were fully insured. Moreover, money market mutual funds, which have some of the same features as bank transactions accounts and generally offer higher returns than bank deposits, today hold over $2 trillion, which suggests that many Americans do not see the additional risk involved in holding money market fund shares as particularly significant. Against this background a relevant question for the Congress is whether deposit insurance should be converted into a governmentally protected all-purpose investment vehicle.

Another argument put forth in favor of an increase in the coverage limit is that it would significantly assist community banks in meeting their liquidity and funding needs, and would counteract the competitive disadvantage that community banks believe they face vis-à-vis large banks. Those who hold this view attribute the continuing increase in the average size of deposits at large banks, in both nominal and real terms, to the widespread belief that a "Too-Big-To-Fail" doctrine protects large banks. While it is exceedingly difficult to know whether or to what extent the perception of such potential support for large banks actually affects depositor behavior, the vast holdings of liquid assets in money market mutual funds suggest that yield, rather than safety may be a more significant motivating factor.

Whether an increase in the coverage limit would in fact enhance community bank funding is speculative at best. It is not at all clear that increasing the limit would result in a net increase in the deposits of the banking system. Depositors who multiply insurance coverage today by using multiple banks might simply consolidate their deposits in a single bank if coverage were raised, and there is no way of determining who would ultimately, when the switching process ended, benefit. Similarly, if a coverage increase did attract new funds into the system, it is not at all clear that the benefits would flow to smaller banks. Large, aggressive institutions might simply use the expanded coverage to offer an even more extensive governmentally protected investment vehicle to wealthy customers, with the consequence of increasing the liquidity pressures felt by smaller banks.

If there is a compelling case to be made for increasing the insurance limit and indexing it to inflation, it remains to be made. Consequently, we believe that Congress should move very cautiously in this area, and while it is certainly true that a coverage increase would be less problematic in the context of properly priced deposit insurance coverage, we think this proposal raises some fundamental questions that need to be addressed.[2]

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[2] One such question is whether insuring virtually a limitless amount of funds is part of the intent of deposit insurance. Clearly, it would be much easier to decide what to do with the existing $100,000 insurance limit if it were a hard and fast upper bound on coverage that was strictly enforced. There have been efforts to devise ways to limit the total coverage or lifetime payouts that could be obtained by any one individual

Conclusion

Today we have the opportunity to undertake comprehensive Federal deposit insurance reform when both the banking industry and the deposit insurance funds are strong. A primary goal of reform should be to reduce the current cross subsidization embedded in the current system, including the inequitable treatment of national banks in the current use of the fund to pay the costs of state nonmember bank supervision.

The OCC supports the FDIC staff recommendations to merge the BIF and SAIF and to eliminate the current constraints on premiums, particularly the mandated zero premiums for well-managed, well-capitalized banks. We favor elimination of the fixed DRR of 1.25 percent of insured deposits and the empowerment of the FDIC to establish a size range for the fund, based on an assessment of the risks the fund faces. Regarding proposals to increase the insurance coverage limit of $100,000, we have not seen compelling evidence to date that increasing the insurance coverage would either further the purpose of Federal deposit insurance or help to alleviate the liquidity and funding pressures of community banks.

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which have generally been rejected on grounds of administrative complexity. In light of the advances that have been made in information technology, those proposals may deserve a second look.

Comptroller of the Currency
Administrator of National Banks

Reforming the
Funding of
Bank Supervision

July 2001

Introduction

This paper addresses a fundamental flaw in our system of bank supervision — the way supervision is funded. It also offers a proposal for fixing this flaw. The proposal not only would enhance the resources available to assure quality supervision of our nation's banking system, but would reduce the assessments now imposed on both national and state banks to pay for their own supervision — with no additional cost to taxpayers.

Background

Under the present system, national banks pay the full costs of their supervision, through assessments levied on them by the Office of the Comptroller of the Currency (OCC), the federal agency that charters and supervises national banks.

State-chartered banks, by contrast, pay only for that small fraction of their supervision that is provided by state supervisory agencies. The predominant part of state bank supervision actually comes from two *federal* agencies, the Federal Reserve System (FRS) and the Federal Deposit Insurance Corporation (FDIC).[1] These federal agencies perform exactly the same supervisory functions for state banks as the OCC performs for national banks. The main difference is that the FRS and the FDIC do not assess state banks for the costs of their supervisory services.

In 2000, these two federal agencies spent almost $1 billion on state bank supervision, none of which was recovered from the banks they supervise.

[1]The FRS supervises state banks that have elected to become members of the Federal Reserve System. The FDIC supervises federally insured nonmember state banks.

The current situation is a problem that Congress needs to fix because:

It's Unfair. The present system is doubly unfair to national banks: they not only are fully charged for the costs of their supervision, but they also have contributed a substantial portion of the deposit insurance premiums that the FDIC relies on to fund its supervision of state nonmember banks. The present system also unfairly imposes on taxpayers and on the FDIC insurance fund the costs of federal supervision of state banks.

It Distorts the Dual Banking System. Healthy competition in the quality of supervision and innovation in meeting the needs of banks and their customers should lie at the heart of our dual banking system. Unfortunately, today a primary focus of this competition is on price. Because state banks receive a federal subsidy for the predominant part of their supervision, there is a cost incentive for banks to avoid or depart from the national charter in favor of the heavily subsidized state charter. This inevitably tends to undermine a vigorous and healthy dual banking system.

It Compromises Safety and Soundness. The present system of funding bank supervision works pro-cyclically. It threatens national banks with additional cost burdens in times of economic stress, and it imposes constraints on supervisory resources at the very time they are most likely to be needed. When there is widespread stress in the banking system, as there was in the late 1980s and early 1990s, significantly increased supervisory attention is demanded and supervisory costs rise. As this occurs, healthy national banks, which already pay more than their state counterparts, face the prospect of substantial increases in assessments to pay the costs of more intensive supervision of problem banks. This creates a strong incentive to convert to a state charter. Such conversions, in turn, reduce the resources available to OCC to fund increased supervisory needs.

It's Inconsistent with Deposit Insurance Reform. A fundamental principle at the heart of deposit insurance reform is that subsidies should be eliminated. Healthy, well-managed banks should not be required to bear the costs and risks presented by less well-managed, riskier banks. By the same token, national banks should not be forced to bear the costs of supervising and insuring state banks. Any proposals to reform the deposit insurance system must inevitably come to grips with this inequity in the system, just as they must focus on such fundamental issues as the appropriate size of the insurance fund and how rebates, if any, should be distributed. Since the principal purpose of bank supervision is to protect the insurance fund, the manner in which supervision is funded is inextricably bound up with the subject of reform of the deposit insurance system.

The following discussion elaborates on each of these points.

The Present System is Unfair to National Banks and to Taxpayers

The three federal bank supervisory agencies — the OCC, the FRS, and the FDIC — perform virtual identical functions with respect to the banks they supervise, as is demonstrated by Table 1. Indeed, for more than 30 years, whenever Congress has enacted new bank regulatory laws,

Table 1 **The Federal regulatory agencies have similar supervisory responsibilities.**

Responsibilities	OCC	FDIC	FED
Safety and soundness exams	X	X	X
CRA Exams	X	X	X
Fair Lending Exams	X	X	X
Enforce Bank Secrecy Act	X	X	X
Regulation	X	X	X
Entry	X	X	X
FFIEC	X	X	X
Enforce the Securities Exchange Act of 1934	X	X	X
Branch Applications	X	X	X
Merger & Consolidation Applications	X	X	X
Enforce Capital Requirements and PCA	X	X	X
Truth in Lending Act Examinations	X	X	X
Right to Approve Directors and Senior Execs	X	X	X
Authority to Prescribe Oper and Mgrl Stds	X	X	X
Supervisory Enforcement Actions	X	X	X
Supervise Foreign Activities	X	X	X

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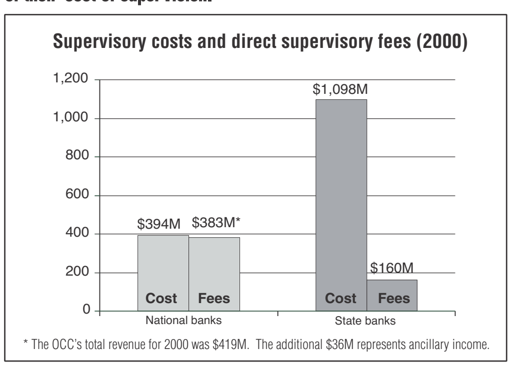
it has almost always parceled out identical supervisory and enforcement responsibilities to the three federal agencies. As a result, the FRS and the FDIC today perform the predominant part of state bank supervision.

Yet the burden of funding supervision falls with vastly disproportionate weight on national banks. As shown in Table 2, virtually the entire amount of the cost of national bank supervision in

Table 2 **Supervisory fees paid by national banks cover 100% of their cost of supervision. Supervisory fees paid by state banks cover 15% of their cost of supervision.**



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2000 was borne by national banks. By contrast, only 15 percent of the total cost of state bank supervision — that is, the costs of both state and federal supervisors — was paid by state banks, in the form of assessments by their state supervisors. The lion's share of these costs — 85 percent — reflecting the costs of the FRS and the FDIC, were absorbed by those federal agencies.

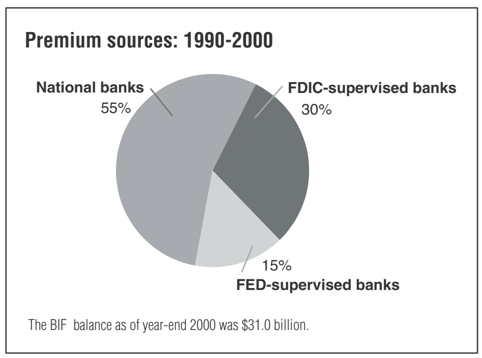
To understand how this federal subsidy unfairly impacts taxpayers and national banks, it is important to understand how the FRS and the FDIC are funded and how those funds are spent.

The FRS derives most of its revenues from open market operations — that is, from the earnings on its portfolio of government securities. Any portion of those earnings remaining after the FRS subtracts its costs of operation are paid over to the U.S. Treasury for the benefit of taxpayers. In 2000, the FRS spent about $300 million (out of $31 billion in total revenue) on its supervision of state banks. Thus, the costs of supervision of state banks by the FRS are, in practical effect, borne by all American taxpayers.

The FDIC's operating revenues are taken out of the deposit insurance funds, which have been built up over the years through the payment of premiums by all insured banks. In 2000, the FDIC tapped into the funds for a total of $1.2 billion, of which $638 million was spent on the supervision of state banks. Of this amount, $568 million was attributable to the FDIC's supervision of state-chartered commercial banks, and $70 million to its supervision of state-chartered thrift institutions.

As the holders of the largest share of the nation's bank deposits, national banks have always been the largest contributors to the bank insurance fund, and therefore to FDIC revenues. As shown in Table 3, national bank contributions today account for almost 55 percent of the funds in the FDIC's

Table 3 **Over one-half of the premiums paid into the bank insurance fund since 1990 came from national banks.**



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Bank Insurance Fund — and, by extension, 55 percent of the earnings that are used by the FDIC to supervise state nonmember commercial banks. ***In other words, 55 cents of every dollar expended by the FDIC on state nonmember commercial bank supervision is attributable to payments by national banks.***

To be sure, state banks have contributed to the insurance funds just as have national banks. *But the fact remains that state banks receive their federal supervision free of cost, while national banks bear the full cost of their supervision.*

There is no justification for a federal policy that subsidizes state banks, yet leaves national banks to bear the full cost of their supervision. Such a policy is especially unwarranted when the majority share of that subsidy is involuntarily funded by national banks through their contributions to the FDIC insurance fund.

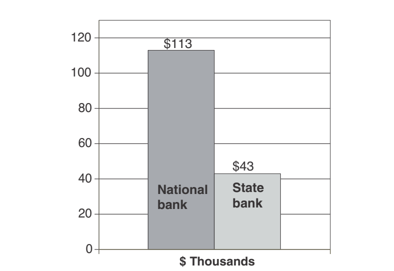
The Present System Undermines the Dual Banking System

Historically, the choice between a national or state charter centered on such things as supervisory philosophy and responsiveness, examination quality, and the scope of permissible activities. The cost of supervision was generally a minor factor. But that's no longer the case.

Today the costs of supervision have increased by orders of magnitude, largely because of laws that Congress has put in place over the past three or four decades to strengthen supervision and to increase protections for consumers — laws that Congress has charged the *federal* supervisors with the responsibility for enforcement. Since the FRS and the FDIC absorb those costs for state banks, while the OCC must pass them on to national banks, the disparity in supervisory costs paid by state and national banks has increased commensurately.

Thus, as shown in Table 4, state banks today pay supervisory costs on average less than half of what comparably sized national banks pay.

Table 4 **Because state banks pay only for supervision costs incurred by states, their supervisory fees average less than half those of national banks.**



Average fees paid in California, Delaware, Florida, Illinois, New York, and Texas, 2000.

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To compound the unfairness, many state bank supervisors today actively proselytize for charter conversions on the basis of the fee differential, in effect exploiting the value of the subsidy provided to state banks by the taxpayers and the FDIC. Thus, the fee disparity creates a significant incentive for a banker to choose a state over a national charter — to opt, in effect, to be the recipient, rather than the donor, of a subsidy.

If large numbers of banks were to make that choice — and the current pressures for cost reduction gives them a strong incentive to do so — the national bank charter could be seriously undermined. The result, perversely, would ultimately be to *increase* the cost to taxpayers and the insurance fund, since banks that convert from national to state charters would no longer pay the full costs of their federal supervision, and it would fall to the FRS and the FDIC to pick up *all* of the additional supervisory costs.

The Present System Compromises Safety and Soundness

The current funding system works pro-cyclically to *reduce* supervisory resources precisely when they are most likely to be needed and to increase the cost burdens on national banks at the very time they are grappling with an economy under stress. Of all the perversities in our system, none is more serious.

We saw this process at work during the wave of large bank failures in the late 1980s and early 1990s — a period of stress in the banking system not seen since the Great Depression. Supervisors were under mounting pressure to monitor and manage the crisis. Yet each bank failure translated into a reduction in the base on which assessments could be levied to support the agencies' increased costs. At the OCC this meant significant increases in assessment rates — 14 percent in 1989, another 11 percent in 1991, and a whopping 30 percent in 1992.

Assessment rates were subsequently lowered when the crisis subsided and the industry returned to health. But it is unfair that our system requires well-managed banks to provide the additional supervisory resources needed to deal with problem institutions. *This is a flaw in the system that must be addressed*.

Moreover, even in times of relative economic calm, the present system can adversely affect the supervision of national banks. Given the concentration of assets in the banking system today, the loss of even a single large national bank — whether due to merger, conversion, or failure — could have a huge impact on the OCC's operating budget. Faced with the loss of a substantial part of its assessment base, the OCC would have only two choices: either to reduce its supervisory resources or to increase assessments on the remaining institutions.

State bank supervisors face a similar problem. In almost half the states, a single bank accounts for 25 percent or more of the asset base on which state supervisors base the assessments they need to fund their offices. Thus, the loss of such a large bank could have a crippling effect on a state supervisor's ability to provide quality supervision.

Deposit Insurance Reform Offers an Opportunity to Mend the Present System

A fundamental principle on which all of the current proposals for deposit insurance reform are based is that cross-subsidies in the system should be eliminated. Banks should contribute to the insurance funds based on the risks they present, and healthy banks should not be required to bear the costs and risks of providing deposit insurance to poorly managed, troubled banks.

Eliminating the fee disparity between national and state banks is an inextricable component of deposit insurance reform. National banks have, in effect, been forced to contribute more to the deposit insurance fund than they rightfully should, because more than half of their contributions to the fund go not for insurance coverage, but to defray the FDIC's costs of supervising state banks. *Any proposal to reform deposit insurance must deal with this cross-subsidy as much as it must deal with the risk subsidy provided by less risky banks*.

The FDIC's initiative to review and revise the deposit insurance system has focused on a number of fundamental issues relating to such questions as how deposit insurance premiums should be set, what the appropriate size of the deposit insurance funds should be, and how rebates, if any, should be distributed once the size of the fund exceeds some specified limit. Although some aspects of the FDIC's proposal are controversial, the debate over deposit insurance reform has been characterized by broad agreement that any reform program should advance the goals of efficient and equitable distribution of the costs and benefits of deposit insurance.

In that context, it's particularly important that we address the supervisory funding issue. *As long as premium income or the revenue it generates is used to fund the federal supervision of only one part of the industry, the FDIC's deposit insurance premium structure — even a revised one — cannot equitably price insurance coverage*. Remedying this inequity and separating the actual costs of the FDIC's supervisory functions from the costs of providing deposit insurance is an essential step toward efficient and rational pricing of both.

How to Fix the Problem

Any proposal for reform of our system of supervisory funding must pass several basic tests. It should

- Strengthen both the federal and state supervisory processes, and protect them from the impact of random structural changes in the banking system;
- Enhance the *qualitative* aspects of competition within the dual banking system;
- Promote a fair and efficient deposit insurance system, and
- Ensure that all supervisors, state and national, have adequate, predictable resources available to carry out effective supervisory programs.

While there have been many different proposals to those ends, we believe that the most straightforward solution would be to develop a common approach to funding supervision. Since effective supervision is a critical component of a sound deposit insurance system — and since state nonmember supervision is already funded from the FDIC insurance fund — it makes sense to extend the existing arrangement to cover the costs of both state *and* national bank supervision from the FDIC fund. In other words, instead of funding supervision through direct assessments on banks, it should be funded by payments to supervisors — the OCC and state supervisors — from the insurance fund, to which *all* banks contribute.

How Would It Work?

Under a proposal the OCC has developed, the costs of both national bank supervision by the OCC and state bank supervision by the states would be paid from the FDIC insurance funds, as follows:

- Working with the FDIC, the OCC and state supervisors would jointly develop a formula for allocating funding based initially on current levels of funding.
- The formula would take into account both the number of institutions and total assets under supervision, as well as the financial condition and growth of the institutions.
- In subsequent years, the baseline allocation would be no less than the supervisors' costs for the preceding year, unless the baseline were adjusted to take account of changes in relevant factors.
- In no event would allocations exceed the investment earnings of the insurance funds for the preceding year. If earnings were insufficient to cover the baseline allocations, payments would be reduced pro rata. No payments could be made from the funds' principal.

- The agencies would retain the authority to impose supplemental assessments on their banks to meet unusual demands.

In short, this proposal would transfer the direct costs of supervision from the assessment process to the insurance funds — which, of course, have been built up by the very same banks that have paid national and state assessments.

The proposal would not involve any new costs for state banks. Indeed, the proposal envisages that assessments on state banks would be eliminated or reduced significantly.

Can the Funds Afford It?

It is clear that the FDIC funds could easily carry the costs of these allocations. In fact, the Bank Insurance Fund (BIF) alone could support the additional OCC and state supervisory costs. Today BIF holds over $31 billion in assets. Over the past five years, BIF's investment income — that is, excluding any premium income — has averaged more than $1.6 billion a year, or nearly 140 percent of the *combined* 2000 supervisory expenses of the OCC, FDIC, and the 50 state supervisors. Thus, even in the absence of premium payments, BIF is currently generating more than enough investment income to defray the supervisory expenses of the OCC and the states, and the FDIC as well.

What Benefits Would It Bring?

There would be enormous benefits to such a new approach to the funding of supervision, with no perceptible downside. Specifically,

- It would place supervision on a sounder and fairer footing, relieving national banks of the burden of subsidizing their state bank competitors, without threatening FDIC resources.
- It would be a step toward allocating the costs and benefits of deposit insurance in an equitable and efficient manner, thus facilitating deposit insurance reform.
- It would ensure that all supervisors have the resources necessary to provide effective bank supervision, regardless of changes in the economy or the structure of the banking system.
- It would revitalize the dual banking system to move beyond the current charter price competition and recapture the elements of the dual banking system that have made it vital to the fabric of our nation's banking system: creativity, efficiency, and healthy competition.