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DEPOSIT INSURANCE REFORM

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Committee on Financial Services
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Mr. Chairman, Congresswoman Waters, and Members of the Subcommittee, I appreciate the opportunity to comment on the Federal Deposit Insurance Corporation's recent paper recommending reform of the deposit insurance system. The FDIC staff and former Chairman Donna Tanoue should be commended for initiating the policy discussion of deposit insurance reform. The FDIC staff report is a thoughtful document that provides a useful starting point for this important review.

We are also grateful for the Subcommittee's initiative in holding a series of hearings on the FDIC's report. The Treasury Department has a substantial interest in this issue as we have a critical role to play in deposit insurance. The deposit insurance funds have authority to borrow up to $30 billion from the U.S. Treasury. In addition, Congress has assigned to the Secretary of the Treasury the responsibility for determining, upon the recommendation of the FDIC Board and the Federal Reserve Board and in consultation with the President, whether the resolution of a failed bank poses a systemic risk to the financial system. Our comments, at this time, are general in nature, focusing on the key policy issues raised in the FDIC paper. We look forward to working with the Subcommittee on the details of implementing reforms in the near future.

We are in *general agreement* with the FDIC report on three points. First, the potential pro-cyclical effects of deposit insurance pricing and reserving should be reduced; reserves should be allowed to grow when conditions are good in order to better absorb losses under adverse conditions without sharp increases in premiums. Second, all insured depository institutions should pay premiums on current deposits, with potential rebates taking into account each institution's recent history of premium payments. Third, the bank and thrift insurance funds should be merged.

However, we have *different views* in two areas. First, we would give priority to reforms that would charge every institution a premium on current deposits that is relatively stable over time, and we would prefer not to extend the complexity of the risk-based premium structure at this stage. Second, the deposit insurance coverage level should remain unchanged.

Reducing the Pro-cyclical Effects of Deposit Insurance Pricing and Reserve Policies

The potential pro-cyclical effects of deposit insurance pricing and reserving should be reduced; reserves should be allowed to grow when conditions are good in order to better absorb losses under adverse conditions without sharp increases in premiums. The existing designated reserve ratio of 1.25 percent of reserves to insured deposits was historically derived roughly as the average reserve ratio over part of the FDIC's history. As such, it is reasonable to first ask whether it is representative of the FDIC's current and prospective risks.

The reforms that the Congress adopted in the late 1980s and early 1990s have in important ways served to protect taxpayers and should in principle have reduced the FDIC's loss exposure. Congress required the FDIC to maintain reserves equal to 1.25 percent of insured deposits and, if losses cause the fund to fall below that target, to assess the banking industry whatever is necessary to replenish reserves. Furthermore, reforms that raised bank capital requirements, mandated supervisors to take prompt corrective action when a bank becomes troubled, and required the FDIC to resolve failures in the least costly manner all have served to reduce the risk of loss to the insurance funds. While these reforms have likely lowered the FDIC's risks, they have not yet been tested in a severe adverse environment.

It should also be noted that some trends during the past decade have probably increased certain risks that the FDIC faces. Banking industry consolidation has increased the probability that reserves could be depleted by the failure of a few very large banks. And increased industry dependence on secured borrowings in recent years may also reduce the FDIC's ability to recover funds from a failed bank.

Even if the current designated reserve ratio is retained, it should be noted that it was originally based on the *average* reserve ratio over some historical period. Thus it is logical to provide for reserve growth above that level when conditions are good (and for reserves to decline below that level when conditions are unfavorable).

Allowing growth above a designated reserve ratio in good times, or growth within a wide range, would not only afford greater room for the insurance fund to handle bank failures without exhausting its resources, but it would allow for more stable premiums that would smooth over time the costs borne by the industry. The FDIC would be better able to avoid imposing sharp premium increases on the industry, which could have a counterproductive pro-cyclical effect when the economy is under stress. In this context, the Treasury believes that it would be appropriate to eliminate the existing requirement that premiums rise to a minimum of 23 cents per $100 of domestic deposits when the fund is expected to fall short of the designated reserve ratio for more than a year.

The FDIC's recommendations suggest two ways to mitigate the pro-cyclical effects of deposit insurance pricing: (1) allow the reserve ratio to fluctuate within a (relatively narrow) range, within which premiums would not change; and (2) whether or not a range is established, allow for surcharges or rebates that are designed to bring reserves back to the designated reserve ratio – or back within the target range – gradually over a period of years. The FDIC's suggested range (only 10 basis points above or below the designated reserve ratio) is quite narrow, and we believe that a much wider range would more effectively smooth premium expenses over time. Furthermore, the FDIC Board should have some discretion to adjust the range within which the reserve ratio may fluctuate in response to changes in industry risks and conditions.

While we believe that premiums should be structured to limit pro-cyclical effects, designing potential means to accomplish this will be a challenge. Even with an ample range within which the reserve ratio can fluctuate, the existence of a target ceiling and floor on reserves, in itself, imposes a pro-cyclical bias in pricing – due to the necessity that some surcharge would have to apply when reserves fall below the floor. To offset this pro-cyclical bias, it may be necessary to give the FDIC Board discretion to modulate increases in premiums in some manner consistent with the overall health of the banking industry. Considerable attention will be required to develop practical formulas to achieve the desired counter-cyclical effects.

Charging All Institutions a Premium Based on Current Deposits

All insured depository institutions should pay premiums on current deposits, with potential rebates taking into account each institution's recent history of premium payments. Banks and thrifts benefit every day from deposit insurance, and they should compensate the FDIC for that benefit, preferably through relatively small, steady premiums. Most banks and thrifts now pay no premiums for deposit insurance, which creates incentives to increase deposits and thus raises the FDIC's uncompensated risk exposure.

The FDIC's existing capacity to absorb losses comes primarily from the high premiums paid by institutions in the first half of the 1990s. More recently, some institutions have been able to rapidly increase their reliance on insured deposits without providing any compensation to the FDIC. In addition, hundreds of other banks and thrifts chartered within the past few years have never paid deposit insurance premiums.

A deposit insurance system where all banks and thrifts pay modest premiums could still allow for rebates when reserves grow beyond some upper bound. If such a system were designed, we would agree with the FDIC staff's suggestion that any rebates be based on each bank's past contributions to the insurance fund. In addition, having premiums based on current deposits combined with rebates based on past contributions would over time require proportionally greater net payments from institutions with rapidly increasing deposits than from institutions with deposits growing more slowly or declining.

While we agree with the FDIC staff report to this point, the FDIC goes further in advocating a substantial refinement of the current system of risk-based premiums. In fact, a revised risk-based premium structure is central to the FDIC proposal.

Although the idea of risk-based premiums has conceptual appeal, we would give priority to reforms that would charge every institution a premium on current deposits that is relatively stable over time, and we would prefer not to extend the complexity of the risk-based premium structure at this stage. Congress authorized the FDIC in 1991 to establish risk-based premiums, and the FDIC developed a matrix of rates that at present range from zero to 27 basis points based on an institution's capital and supervisory rating. Statutory restraints imposed in 1996, however, have prevented the FDIC from charging most banks and thrifts any premium.

Ideally, an institution's risk-based premium should account for the riskiness of its assets, the structure of its liabilities, the strength of its capital base and management, and the effect that its failure would have on insurance fund reserves. Differences in premiums between a very healthy, low-risk bank and a weak bank may have to be quite large to have the desired behavioral effects. Risk adjustments to premiums should also consider the interaction between risk-based capital requirements, prompt corrective action and bank closure rules, and deposit insurance. Given these considerations, we think that the calibration of risk-based premiums to provide the desired incentives would prove very challenging. Thus, while the FDIC should have authority to charge every institution a premium on current deposits that is not subject to sharp fluctuations over time, we would recommend that any further adjustments to risk-based premium categories and rates be pursued at a later stage.

While we recommend that all institutions pay premiums assessed on current deposits, we also feel that it would be a missed opportunity not to consider what should constitute the assessment base. Under the current structure, to the extent that banks are assessed at all, they are charged only on banks' total domestic deposits. Yet, in the event of bank failure, secured liabilities have a higher claim than domestic deposits (and the FDIC, which would assume the claims of insured depositors) on bank assets. Thus increased reliance on secured liabilities by depository institutions may increase the FDIC's loss exposure. The Gramm-Leach-Bliley Act, by giving community banks broader access to Federal Home Loan Bank (FHLB) advances, has accentuated our concerns about these potential risks. Reform efforts should consider whether the existing assessment base should be modified to account for the effect of liability structure on FDIC's expected losses.

Merging the Bank and Thrift Insurance Funds

The bank and thrift insurance funds should be merged. We strongly support a merger of the bank (BIF) and thrift (SAIF) insurance funds. A larger, combined insurance fund would have a greater ability to diversify its risks than either fund separately. It would make sense to merge the funds while the industry is strong and while a merger would not unduly burden either BIF or SAIF members. A merged fund would also prevent the possibility that institutions posing similar risks could pay significantly different premiums for the same FDIC insurance, as was the case in 1995 and 1996. Incentives created by a premium disparity could result in a wasteful expenditure of industry resources in order to avoid higher assessments. Finally, a merger would underscore the fact that BIF and SAIF are already hybrid funds: each one insures the deposits of commercial banks, savings banks, and savings associations. Indeed, commercial banks now account for over 40 percent of all SAIF-insured deposits. A merger would simply recognize the commingling of the funds that has already taken place and that is likely to continue.

Deposit Insurance Coverage Level

The deposit insurance coverage level should remain unchanged. We see no evidence that the current limit on deposit insurance coverage is burdensome to consumers. Nor do we see evidence that increasing coverage across the board would enhance competition in the banking industry. Moreover, an increase in the coverage level would increase risk to the FDIC and, ultimately, taxpayers. Thus it would be imprudent to increase the FDIC's exposure at this time by raising the deposit insurance limit.

Increasing the deposit insurance limit would do little for the typical saver, given that the median deposit balance is far below the current ceiling. According to the most recent consumer finance survey data from the Federal Reserve, only 2 percent of households with deposit accounts held any uninsured deposits. The median income of these households was approximately double the median income of households with deposits under $100,000. Thus, any potential benefit from expanding deposit insurance coverage would likely accrue primarily to upper-income individuals.

Ample opportunities already exist for savers with substantial deposits to obtain FDIC coverage equal to several multiples of $100,000. Without much difficulty, they may place deposits in several FDIC-insured institutions or establish accounts within the same institution under different legal capacities that qualify for separate coverage (individual, joint, and IRA accounts). In addition, many consumers feel completely comfortable putting substantial amounts into uninsured but relatively safe money market mutual funds. It is not surprising, therefore, that we have found no evidence of consumers expressing concern about the existing deposit insurance limits.

Competition is critical to keeping banks vital and promoting consumer benefits. Since the existing coverage limit does not appear to restrain consumer benefits, we are deeply skeptical that an increase in the coverage level would promote competition and have a meaningful impact on the ability of community banks to obtain funds.

To the extent that an increase in coverage does result in a conversion of uninsured liabilities to insured deposits, the resulting financial safety net expansion would reduce incentives for market discipline and potentially increase financial system risk. The large increase in insurance coverage at the beginning of the 1980s was, of course, only one of several factors leading to the subsequent savings and loan and commercial bank problems. Nonetheless, it surely contributed to excessive risk-taking by many depository institutions that failed and raised the ultimate cost of those failures.

Funding of Supervision Costs

In considering reform of deposit insurance pricing, it is important to recognize that a significant portion of insurance fund expenditures is not for the resolution of failing institutions, but for the FDIC's supervision of almost 5,600 state-chartered commercial and savings banks. While these state banks pay fees for the fraction of supervision performed by state authorities, they are not charged fees for the significant share of supervision that is performed by the FDIC. National banks and savings associations, by contrast, are charged for 100 percent of their supervision, and in addition must subsidize FDIC's costs to supervise state banks through their contributions to the insurance funds (and the fund's earnings on those contributions). This uneven distribution of supervision costs is a real problem that should be addressed. All of the federal and state bank supervisory agencies should continue to have the resources necessary to promote safety and soundness. We believe that the OCC's proposal is an interesting approach that deserves further consideration, and there may be other approaches and considerations that should also be explored. We look forward to working with incoming FDIC Chairman Powell and the FDIC Board to devise a solution to this problem.

Thank you for the opportunity to appear here today. I look forward to working with the Subcommittee on these issues.